SUPREME COURT, U. S.

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IN THE

Supreme Court of the United States

October Term, 1974

No. 74-432

COMMUNITY BANK, *et al.*, *Petitioners,*

vs.

FEDERAL RESERVE BANK OF SAN FRANCISCO, and BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,

Respondents.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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IN THE

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October Term, 1974
No. .....

COMMUNITY BANK, *et al.*, *Petitioners,*

vs.

FEDERAL RESERVE BANK OF SAN FRANCISCO, and BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,

Respondents.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Petitioners Community Bank, California Republic Bank, American Pacific State Bank, Coast Bank, Savings Bank of Mendocino County, Valencia Bank, The Bank of Downey, The Westlands Bank, Bank of Upper Lake, Mother Lode Bank, First City Bank of Rosemead, Shasta County Bank, Hacienda Bank, Cerritos Valley Bank, Independence Bank, Napa Valley Bank, Century Bank, The Bank of Finance, El Camino Bank, The County Bank, Bank of Rio Vista, California Pacific Bank, Golden State Bank, Southwest Bank, First State Bank of Southern California, Home Bank, and Santiago Commercial Bank, and each of them, respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit, entered in this proceeding on July 22, 1974.

Opinions Below.

The Opinion of the United States District Court, Central District of California, is unreported and is reproduced in Appendix A hereto. The Opinion of the United States Court of Appeals for the Ninth Circuit is not yet reported and is reproduced in Appendix B hereto.

Jurisdiction.

The judgment of the Court of Appeals (App. B) was entered on July 22, 1974. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

Federal and State Statutes and Regulations Involved.

This case involves the Federal Reserve Act,[1] 12 U.S.C. §§248(i), 248(o) and 342; Regulation J,[2] 12 CFR Part 210; California Commercial Code §§4103, 4301, and 4302. These are printed in pertinent part in Appendix C hereto.

Questions Presented.

1. Does the Act and Reg J promulgated thereunder apply to the collection of checks payable by nonmember, nondepositing banks?[3]

2. Does the Fed's[4] promulgation of Reg J exceed its statutory authority insofar as Reg J attempts to pre-

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[1]The "Act" herein.

[2]"Reg J" herein.

[3]Banks which are not members of the Federal Reserve System and which do not maintain a clearing account with a Reserve Bank.

[4]As used herein "Fed" means the Federal Reserve System, the Board of Governors of the Federal Reserve System or the Federal Reserve Bank of San Francisco, according to context.

scribe the terms and conditions on which nonmember, nondepositing banks must pay checks presented to them by a Federal Reserve bank?

3. If Reg J is inapplicable to a nonmember, nondepositing bank, does it nevertheless have the status of an "agreement" under California Commercial Code §4103 binding on nonmember, nondepositing banks?

4. Are nonmember, nondepositing banks subject to Federal regulation of their check-paying activities by reason of their use of the ABA Routing number?

Statement of the Case.

Status of Petitioners.

Petitioners are small state banks[5] chartered under the laws of the State of California. None is a member of the Fed and none maintains a clearing account with the Fed. [R. 144.]

Payment of Checks by Petitioners.

Prior to the Amendment of Reg J, effective on November 9, 1972, the Fed presented checks for collection to Petitioners by delivering them in the evening after the close of regular banking hours, accompanied by a "cash letter" which indicated the total amount of such items. [R. 145.] In accordance with §4107(2)[6] and with Reg J §210.9(a), these checks were deemed received by Petitioners on their next banking day.

By midnight of the banking day of receipt of the cash letter, Petitioners returned the items they did not wish to pay and settled the remaining items by sending

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[5]Only one has assets of over $100,000,000; most have assets of less than $50,000,000. [R. 38-75; 148-166.]

[6]All citations are to the California Commercial Code unless otherwise stated.

to the Fed a draft drawn on a correspondent bank. [R. 145.]

This method of payment was proper both under Reg J as it then existed (Reg J §210.9; 210.12) and under the California Commercial Code.

Adoption and Effect of the Reg J Amendment.

Effective November 9, 1972, Reg J was amended in several particulars. The applicable sections are reproduced in Appendix C. Briefly the changes were these:

(a) Reg J §210.9(a)(1) requires a payor bank to settle for demand items *at the close of its banking day of receipt.*

(b) Reg J §210.9(a)(1) authorizes settlement (in addition to cash and remittances that may be approved in the discretion of the Fed) *only* by debit to an account on the books of a federal reserve bank *provided this is done not later than the close of the banking day of the Federal Reserve bank.*

(c) Reg J §210.12(a) provides that *only* if settlement is made at the earlier hour will the payor have the right to revoke the settlement by its midnight deadline.

(d) Two sanctions were added: (i) the payor bank becomes accountable for the item if it doesn't settle at the earlier date and in a manner approved by the Fed (Reg J §210.9(a)(1); and (ii) if the Federal Reserve bank does not receive payment as required, the amount of the item may be charged back to the sender regardless of whether or not the item itself can be returned. (Reg J §210.13.)

By comparison with California law (and Reg J as it existed prior to the Amendment), the effect of these

amendments is to shorten the time allowed a payor bank to settle, to restrict the method of settlement and to curtail the right to revoke the settlement by the midnight deadline. The effect of the sanctions would be to prematurely dishonor checks of Petitioners' depositors whose accounts may have been sufficient to pay such items. The charging back of these items would damage the Petitioners' relationship with their customers. [R. 147.]

Reg J §210.3 declares the regulation to be binding on *all* payor banks to which the Fed presents checks for payment. The Fed reiterated this purpose on numerous occasions. [*e.g.*, R 221; 273; 307.]

The mechanics of imposing a "same day" charge system require the first day to be a double settlement day. [R. 601.] Thus a payor bank, instead of reducing its funds by the payment of a *single* day's accumulation of checks, must pay *two* days' checks. This results in a loss of assets equal to the average daily payout. [R. 146, lines 19-32.] The aggregate loss of assets for the state banks is estimated to be approximately $32,459,000 and the aggregate annual loss of earnings is estimated to be $1,430,000. [R. 38-75; 148-166.]

The Numerical System of Identifying Checks.

Each of Petitioners (and virtually all banks except the non-par banks) now utilize an individual ABA Routing Number or symbol[7] encoded on the bottom edge of their checks in magnetic ink. This symbol constitutes the "machine name" of the bank and enables its checks to be sorted and routed by high speed electronic equipment. [R. 558-567.] If this "machine

[7]Erroneously designated by the Court of Appeals as the "Federal Reserve routing number."

name" were not encoded on a check, the electronic equipment *as presently programmed* would not be able to identify the bank and process the checks. [R. 496; 505; 511; 516.]

The non-par banks do not use an ABA Routing Number but instead use a number composed on the digits 9 or 90 followed by the bank's number. [R. 561.] Under present programming of computers, these checks are excluded from the Federal Reserve check collection system. [R. 560.]

The history of the development of the ABA Routing Number is significant. In 1910 (three years before creation of the Fed) the ABA devised a numerical system for identifying bank checks. [R. 559.] Nonmember and member banks alike used the ABA's numbers and it was not until 1945 that the ABA, in collaboration with the Fed, developed a modification of the ABA number. Among other things, in place of identifying the location of a bank by state or city, it was now identified by Federal Reserve District. This became known as the ABA Routing Number and was used by both member and nonmember banks. In 1954, when electronic equipment came into general use, the ABA Routing Number was encoded in magnetic ink at the bottom of the check, and that practice is now universally in effect. [R. 560.] When a bank is organized, Rand, McNally & Company, the agent of the ABA (*not* the agent of the Fed) assigns these numbers to the new bank, and publishes directories showing the numbers for all banks. [R. 559.]

"Float" and the State Banks' Collection of Checks.

The Fed announced that the goal of the amendments to Reg J was to make available to depositing banks immediately available funds and to eliminate "Federal Reserve Float" where checks were deposited for collection in one Federal Reserve Territory while the paying bank was located in another Territory. [R. 239.]

Prior to the amendment to Reg J the Fed established a payment schedule for checks collected by it providing not more than a two-day deferment of credit by the Fed to the depositing bank. However, on certain checks three days elapsed before the Fed received payment. The one-day difference constituted a large portion of Federal Reserve Float. [R. 203.]

By demanding payment from the paying bank on the date of receipt in immediately available funds, the Fed sought to accelerate payment by one day and therefore eliminate this portion of Federal Reserve Float.

The Fed announced that it would immediately pass on to the depositing bank the credit it received from the paying bank. [R. 205; 239.] But Petitioners cannot deposit their checks for collection with the Fed because they are not members of the Fed nor depositors in a Reserve Bank. [Act, §342.] Petitioners send their checks to their correspondent banks for collection. [R. 495; 505; 510; 515-516.] A correspondent bank, upon receipt of checks for collection from Pe-

titioners, processes the checks and routes them in its sole discretion, some to a local clearing house, some to other commercial banks and some to the Fed by sending them under a single cash letter with the correspondent's own checks. The correspondent bank does *not* give Petitioners immediate credit when Petitioners send checks to it for collection. Instead, the correspondent gives Petitioners "next-day credit" or "next-day availability" for checks received from them for collection. This deferment of credit and withholding availability of funds until the next day represents one day's float for the benefit of the correspondent bank at the expense of Petitioners. [R. 495-497; 504-506; 509-511; 515-517; 518-523; 536-538.]

The net result of the Amendments to Reg J is to subject Petitioners to a same-day charge for incoming checks presented to them by the Fed, but without providing them with same-day credit from the Fed for their outgoing checks *because they have no connection with the Fed.* Thus the Fed clears up *its* float problem by shifting the benefit of the float away from Petitioners to their large correspondent banks, which are members of the Fed.

Petitioners commenced action against the Fed in the United States District Court, Central District of California, seeking an injunction against the imposition of Reg J and seeking a declaration of rights. The basis for federal jurisdiction is 28 U.S.C. 1331(a). The District Court denied the injunction, granted the Fed's motion for summary judgment and denied Petitioners' motion for summary judgment. The United States Court of Appeals for the Ninth Circuit affirmed.

REASONS FOR GRANTING THE WRIT.

I.

Importance of the Case.

This case is the result of yet another attempt by the Fed to regulate the activities of state banks which are not affiliated with the Federal Reserve System.[8] The dual banking system has a long and honorable tradition in our country and provides a valuable check against a single autarchic monetary authority.[9] To maintain the integrity of the dual system, state banks must be protected from encroachments upon their right to be governed by state law rather than Federal regulation. Petitioners submit that this case presents the opportunity to define the limits of permissible Federal regulation of nonmember state banks under the Federal Reserve Act.

II.

The Court of Appeals Has Erroneously Construed the Federal Reserve Act and Has Enlarged the Fed's Regulatory Power Under the Act.

Under the Act the Fed has the power to regulate the collection activities only of its member banks and those nonmember banks which maintain a deposit with a Federal Reserve bank. The pertinent sections are 12

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[8]*Cf.* remarks of Hon. Wright Patman, commenting on the Fed's Proposal to acquire control of nonmember banks' reserve deposits, that the proposal is "still another grab for power" and would "be a direct challenge to the dual banking system and would greatly reduce the power of state banking authorities and the independence of the small banks around the nation." (Reported in the January 29, 1974, edition of the Los Angeles Times.)

[9]R. Robertson & A. Phillips, Optional Affiliation With The Federal Reserve System for Reserve Purposes Is Consistent With Effective Monetary Policies, 1974; D. L. Kemmerer, The ABC's of The Federal Reserve System, pages 31-34 (1950).

U.S.C. §§248(i), 248(o) and 342. (App. C, p. 1) As originally adopted in 1913, the Act authorized only the collection of checks drawn on or deposited by a member bank or another reserve bank. In 1916 the Act (§342) was amended to permit a reserve bank to receive for collection checks drawn upon all banks in its district, and finally in 1917 the authority was extended to accept checks for collection from a nonmember bank provided the nonmember bank maintained an account with a Federal Reserve bank sufficient to offset its transit items. So far as material to this case, this section of the Act has remained the same since 1917.

Congress did not intend the Act to apply to nonmember, nondepositing banks.

During the debates on the 1917 amendment (the first time any mention of nonmember banks appeared in the Act) Congressional and Senate members made statements to the effect that Congress is powerless to regulate nonmember banks. (See remarks quoted in 31 Ops. Attys. Gen. 245, 250-251 (1918), App. D, p. 2.)

In the opinion of the Attorney General of the United States the Act has no application to nonmember banks unless they are depositors in a Federal Reserve bank.

In 31 Ops. Attys. Gen. 245, 248 (1918) (App. D, p. 3) the Attorney General construes the term "nonmember bank" as used in the Act to refer to a nonmember bank that has become a depositor in a Federal Reserve bank, and concludes that *only* those nonmember banks are subject to the Act.

The Act has been judicially construed as not affecting nonmember banks unless they have become depositors in a Federal Reserve bank.

In *Brookings State Bank v. Federal Reserve Bank*, 281 Fed. 222, 226 (D.C. Ore. 1922) the court describes nonmember banks as "being without the pale of the Federal Reserve Act." At page 225 of the Opinion, the Court says that unless a nonmember bank maintains a balance with a reserve bank ". . . it would seem that nonmember banks are not affected by the Act. 31 Opinions of Attorneys General 245."

The Opinion concludes, page 227:

> "I repeat what was said in deciding the matter on preliminary hearing: 'While, under the prevailing custom, the defendant bank [Federal Reserve Bank] could rightfully remit checks and drafts drawn against the plaintiff [nonmember] bank direct to the latter for collection, and could thereby exact payment of them, *it could not impose conditions upon which such payment should be made.*' " (Emphasis added.)

In *Farmers and Merchants Bank of Monroe, North Carolina v. Federal Reserve Bank of Richmond, Virginia*, 262 U.S. 649 (1923) the Fed was attempting to force defendant nonmember bank to pay checks at par. A North Carolina statute authorized a payor bank under certain circumstances to pay a check presented through a Reserve Bank by exchange drawn on its reserve deposits. The Fed asserted the North Carolina statute was unconstitutional. This Court held that the North Carolina banks could elect to be governed by the North Carolina statute and could not be forced to submit to the Fed.

The *Farmers and Merchants* decision is interpreted in *Pascagoula National Bank v. Federal Reserve Bank*

of Atlanta, 3 F.2d 465, 468 (D.C. N.D. Ga. 1924) as follows:

> "That the state having power over the state banker and his business, may regulate his method of receiving and paying out his deposits was ruled in *Farmers' and Merchants' Bank of Monroe vs. Reserve Bank of Richmond*, 262 U.S. 649; 43 S.Ct. 651, 67 L.Ed. 1157, 30 A.L.R. 635."

The significance of *Farmers and Merchants* is that the Fed was prevented from imposing conditions of payment (*i.e.*, at par) on nonmember banks. In the nonpar cases the condition for payment struck down was that remittance be at par. In the instant case, the condition is same-day payment. Petitioners submit this condition also should be struck down. The Court of Appeals decision correctly states (App. B, p. 4) that in *Farmers and Merchants* "The Court only recognized the right of a state to alter the common law rules relating to bank collections." This is a fair summary of the holding of *Farmers and Merchants* but the Court of Appeals erroneously concludes "[t]here is nothing in this [*Farmers and Merchants*] that supports the appellants." Petitioners submit *Farmers and Merchants* not only supports appellants but compels the holding that nonmember state banks are entitled to be governed by the state statute, if they wish, and that the Fed is powerless to force collection of their checks contrary to state law.

The Fed's own interpretation of the Act and the acquiescence of Congress in that interpretation is per-

suasive evidence that the Act does not apply to nonmember, nondepositing banks.

Reg J, Series of 1920[10] authorized each Federal Reserve bank to receive checks for collection from nonmember state banks which maintained balances with a Federal Reserve bank and provided that such nonmember banks "will hereinafter be referred to in this regulation as *nonmember clearing banks.*" (Emphasis added.) The last sentence of the regulation, however, instructed each Federal Reserve bank to promulgate rules and regulations "to be binding upon all member and nonmember banks which are clearing through the Federal reserve bank." The defined term "nonmember clearing banks" was *not* used in this sentence to limit the coverage of the regulation, and the regulation thus applied to *all* banks.

In 1923, the Fed acknowledged that the *Farmers and Merchants Bank* case held that the check clearing system should be voluntary and that "unaffiliated" (*i.e.*, nondepositing, nonmember banks) should not be compelled to forego their right to charge exchange.[11] The Fed then took under consideration what changes should be made in "existent check collection practices in order to conform to the fullest extent to the spirit as well as the letter of these decisions."[12]

Thereafter, the Fed promulgated Reg J Series of 1924[13] superseding the 1920 Series, stating that the regulation had been rewritten to incorporate "the principles governing the collection of checks laid down by

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[10]Reproduced in part at App. C, p. 5.

[11]Annual Report of the Federal Reserve Board (1923), p. 49.

[12]*Id.* p. 50.

[13]Reproduced in part in App. C, p. 6.

the Supreme Court in the Atlanta and Richmond par clearance cases, decided in 1923 . . ." and "to define more clearly the rights, duties and liabilities of the Federal Reserve banks as collecting agents.[14]

In the 1924 Reg J series, Section VI,[15] the Board, mindful of the Supreme Court decisions, authorized the Federal Reserve banks to issue letters of instruction "binding upon any member or nonmember clearing bank which sends any checks to such Federal Reserve bank for collection . . ." No attempt was made to make Reg J binding on *all* nonmember banks. The Board thus recognized the limitations imposed on it by the Supreme Court cases and recognized that its jurisdiction over nonmember banks was dependent upon their maintaining a deposit with a Reserve bank. Reg J remained in substantially this form until 1967 when the Board, forgetting the teaching of the non-par cases, again purported to make Reg J binding on *all* banks to which the Fed presented checks for payment. (Reg J §210.3.) But for 43 years the Fed *did* recognize that it had jurisdiction only over those nonmember banks which maintained the statutory deposits with a Federal Reserve bank.

And, significantly, the Fed requested Congress to give it power over all banks and Congress refused to do so. (See *e.g.*, Board of Governors, 56th Annual Report (1969) at 300; 57th Annual Report (1970) at 187; 58th Annual Report (1971) at 211.

It is well established that the interpretation by an administrative agency of the statute it administers, and

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[14]Annual Report of the Federal Reserve Board (1924), p. 31.

[15]App. C, p. 7.

legislative acquiescence in such interpretation, is of great significance in interpreting the statute. (*F.T.C. v. Bunte Brothers,* 312 U.S. 349, 351 (1941); *Federal Power Comm. v. Panhandle Eastern Pipe Line Co.,* 337 U.S. 498, 513 (1949); *United States v. Cooper,* 312 U.S. 600, 613 (1941).)

To summarize, the Fed attempted to interpret the Act as granting it the authority over nonmember banks so as to force them to remit at par. The courts held to the contrary. The Fed acknowledged this lack of authority, sought such authority from Congress and Congress has not granted it. The Fed again, relying on the same statute, now attempts to exert the same type of authority over nonmember banks involving the "same-day charge" aspect of the check collection system rather than the "par value" aspect. Reg J in 1920 and the present Reg J both purport to impose conditions of payment on nonmember banks. Clearly, if the Fed does not have authority over nonmember banks to require them to submit to a par clearance system, it does not have authority to require them to submit to a same-day charge system.

III.

The Court of Appeals Has Decided a Federal Question in a Way to Conflict With a Decision of This Court.

The decision in the instant case is in direct conflict with *Farmers and Merchants Bank of Monroe v. Federal Reserve Bank of Richmond,* 262 U.S. 649 (1923).

Farmers and Merchants held that the nonmember state banks could properly pay checks in accordance with their state statute, and could not be forced to pay in accordance with the Fed's regulations. There, as here, the Fed was asserting the right to specify the terms

and conditions of payment. The Court of Appeals' decision upholds the assertion in Reg J that the regulation is binding on *all* banks to which the Fed presents checks for payment. This is precisely what Mr. Justice Brandeis held in *Farmers and Merchants* was *not* the law.

The Court of Appeals recognizes that *Farmers and Merchants* struck down Fed's claim it had a duty to establish a universal system of check collection. But the Court of Appeals holds that the amendments to Reg J cannot be viewed as an attempt to establish a universal system of check collection. (App. B, p. 8.)

Such holding ignores the very language of §210.3 of Reg J that the regulation is "binding upon each . . . paying bank . . . to which the Federal Reserve bank . . . presents, sends or forwards a cash item . . ." It also ignores the numerous official statements of the Fed referred to in the Record at pages 414-416[16] which were called to the attention of the Court of Appeals, and which clearly show the intention of the Fed to establish a universal system of check collection.

The Court of Appeals states that the system is voluntary and suggests that Petitioners can remove themselves by eliminating their ABA Routing Number. The evidence [R. 668; 669; 671] shows that the Fed, *if it wishes,* can process checks even though they bear the non-par symbol. The option to present checks to a nonmember state bank thus rests entirely with the Fed and is beyond control of the paying bank.

Since the Fed has demonstrated the capability of presenting checks to *all* banks, regardless of the symbols

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[16]Reproduced in pertinent part in Appendix E hereto.

on their checks, we must take seriously the assertion in Reg J that it is binding on *all* banks.

What else can this be but a universal system of check collection?

IV.

The Court of Appeals Has Decided an Important State Question in Conflict With Applicable State Law.

The Court of Appeals states that Reg J is obviously in conflict with §§4302 and 4301 but the conflict disappears in light of the flexibility provided in §4103. (App. B, p. 9.)

Since §4103 provides that provisions of the Code may be varied by agreement and that Federal Reserve regulations have the effect of agreements, we must first determine what is a "Federal Reserve regulation." Uniform Commercial Code Comment 3 to §4103 (ignored by the Court of Appeals) provides the answer: It is a regulation "issued by the Board in pursuance of its statutory mandate." As Petitioner has shown above, this statutory mandate does *not* include the power to regulate nonmember, nondepositing state banks. Therefore, Reg J, insofar as it is sought to be applied to Petitioners, is not a "regulation" contemplated by §4103 as having the force of an agreement. Not being applicable to Petitioners it is a nullity—no regulation at all for the purposes of this case.

The Court of Appeals reasons that by the use of the ABA Routing Number,[17] Petitioners have created an "agency or sub-agency" which "constitutes the necessary predicate for Federal Reserve Regulations to be

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[17]Miscalled "Federal Reserve routing number" by the Court of Appeals.

binding on nonmember banks." (App. B, p. 10.) It is significant that the "agency or sub-agency" theory is not enunciated in the Uniform Code Comments, nor in the California Comments, but in a 1955 study of the New York Law Revision Commission. In fact, this theory was not presented by the Fed to the Court of Appeals and *Petitioners have had no chance to be heard on the matter.*

Petitioners submit that in view of the history of the development of the ABA Routing Number,[18] the Court of Appeals has drawn an unwarranted legal conclusion from the use of these numbers by Petitioners. When the ABA Routing Numbers were modified in 1945 to include certain symbols of significance only to the Fed, Reg J was not in conflict with state laws governing the collection of checks. State banks paid checks according to their state laws, and the use of symbols having utility only for the Fed was a matter of no moment to the nonmember state banks. This situation continued unchanged after California adopted the Uniform Commercial Code effective in 1965. It was not until the amendments to Reg J were adopted in 1972 that the Fed asserted the numbers gave them jurisdiction over *all* banks. Since Petitioners were already in existence and had already been assigned their ABA Routing Numbers prior to the 1972 amendments, it is utterly without logic to assume that Petitioners' use of these numbers constituted an act on their part creating an "agency or a sub-agency" with the Fed.

[18]Set forth on page 11 of this Petition.

The Court of Appeals states (App. B, p. 12) that elimination of the numbers is commercially feasible, as demonstrated by the current practice of non-par banks, and that if the Federal reserve [sic] number is replaced with a number 9, the checks may be electronically processed. In the sense that computers can be programmed to read practically any symbol, this statement is true. But the undisputed evidence in the record is that the only way Petitioners' checks can be processed *under present programming* is to use the previously assigned ABA Routing Numbers.

If those numbers had to be changed, not only would this require a reprogramming of computers servicing the approximately 14,000 commercial banks in the country[19] but it would require that each and every one of Petitioners' depositors have new checks printed and encoded with a new number. This is *not* commercially feasible,[20] and we are left with the inescapable conclusion that if, by using the traditional numbering system which is the only system now available (other than the system used by the approximately 200 non-par banks in the country), Petitioners *thereby* constitute the Fed their agent or sub-agent, then the Fed's system is *not* voluntary, and Petitioners have been

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[19]Board of Governors, 58th Annual Report (1971), page 266. Since checks drawn on Petitioners might be deposited in any bank in the country, every bank computer in the country would have to be reprogrammed to read the new machine name.

[20]R. 522-523; 537-538. The "feasibility" of Petitioners abandoning the use of their universally known and accepted ABA Routing Numbers is akin to the feasibility of a telephone subscriber abandoning the use of his telephone because carrier pigeons and smoke signals are available.

forced to submit to a Federal regulation which Congress, the Attorney General, the courts and even the Fed itself (for over 40 years) stated was not applicable to them.

The emerging doctrine of "Contracts of Adhesion" is applicable here. The California Courts, over the last 12 years, have repeatedly used this doctrine to prevent injustice. In *Steven v. Fidelity & Casualty Co.*, 58 Cal. 2d 862 (1962) at page 882 it is stated:

> "Indeed, some legal authorities categorize the instant contract and comparable agreements under the term 'contract of adhesion' to give it a more definite place in the law and to emphasize the need for the strict judicial scrutiny of its terms. The term refers to a standardized contract prepared entirely by one party to the transaction for the acceptance of the other; such a contract, due to the disparity in bargaining power between the draftsman and the second party, must be accepted or rejected by the second party on a 'take it or leave it' basis, without opportunity for bargaining and under such conditions that the 'adherer' cannot obtain the desired product or service save by acquiescing in the form agreement."

The Court at page 883 quotes the New Jersey Supreme Court in *Henningsen v. Bloomfield Motors, Inc.*, 32 N.J. 358 [161 A.2d 69, 75 A.L.R. 2d 1]:

> "The task of the judiciary is to administer the spirit as well as the letter of the law. On issues such as the present one, part of that burden is to protect the ordinary man against the loss of im-

portant rights through what, in effect, is the unilateral act of the manufacturer . . . (P. 94 [161 A.2d]).”

In *Frame v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 20 Cal.App.3d 668 (1971), the Court states at page 672:

> “It is true that where the bargaining strength of contracting parties is unequal a contractual provision may be construed to give effect to the reasonable expectation of the weaker party when necessary to avoid injury or unfair imposition which it is shown would be the result of giving literal effect to the terms of the contract.”

See also,

Gray v. Zurich Insurance Co., 65 Cal.2d 263, 269 (1966);

Akin v. Business Title Corp., 264 Cal.App.2d 153, 159 (1968);

Hamilton v. Stockton Unified School District, 245 Cal.App.2d 944, 951 (1966).

In the instant case: (1) the bargaining power[21] of the Fed is far superior to that of the Petitioners; (2) the Petitioners had no expectation that they were naming the Fed as their agent when they accepted their respective ABA Routing Numbers; and (3) Petitioners have no real choice to accept or reject the ABA Routing Numbers.

Petitioners submit the consequences of their acts must be given a reasonable interpretation favorable to them, and not be deemed to create a contract that bears all the characteristics of a contract of adhesion.

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[21]The “bargain” is strictly unilateral in favor of the Fed.

Conclusion.

For the foregoing reasons, a writ of certiorari should issue to review the Judgment and Opinion of the United States Court of Appeals for the Ninth Circuit.

Respectfully submitted,

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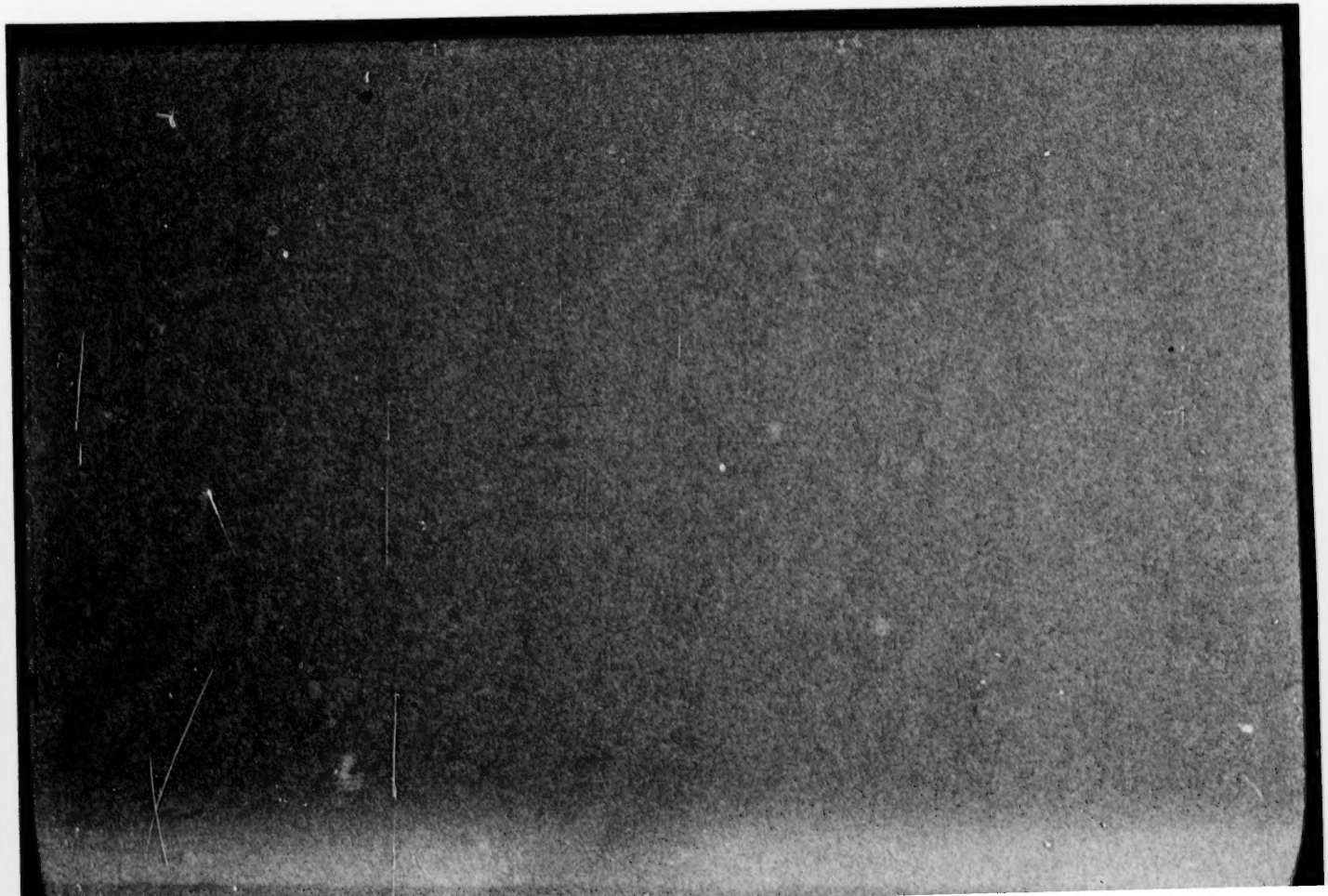
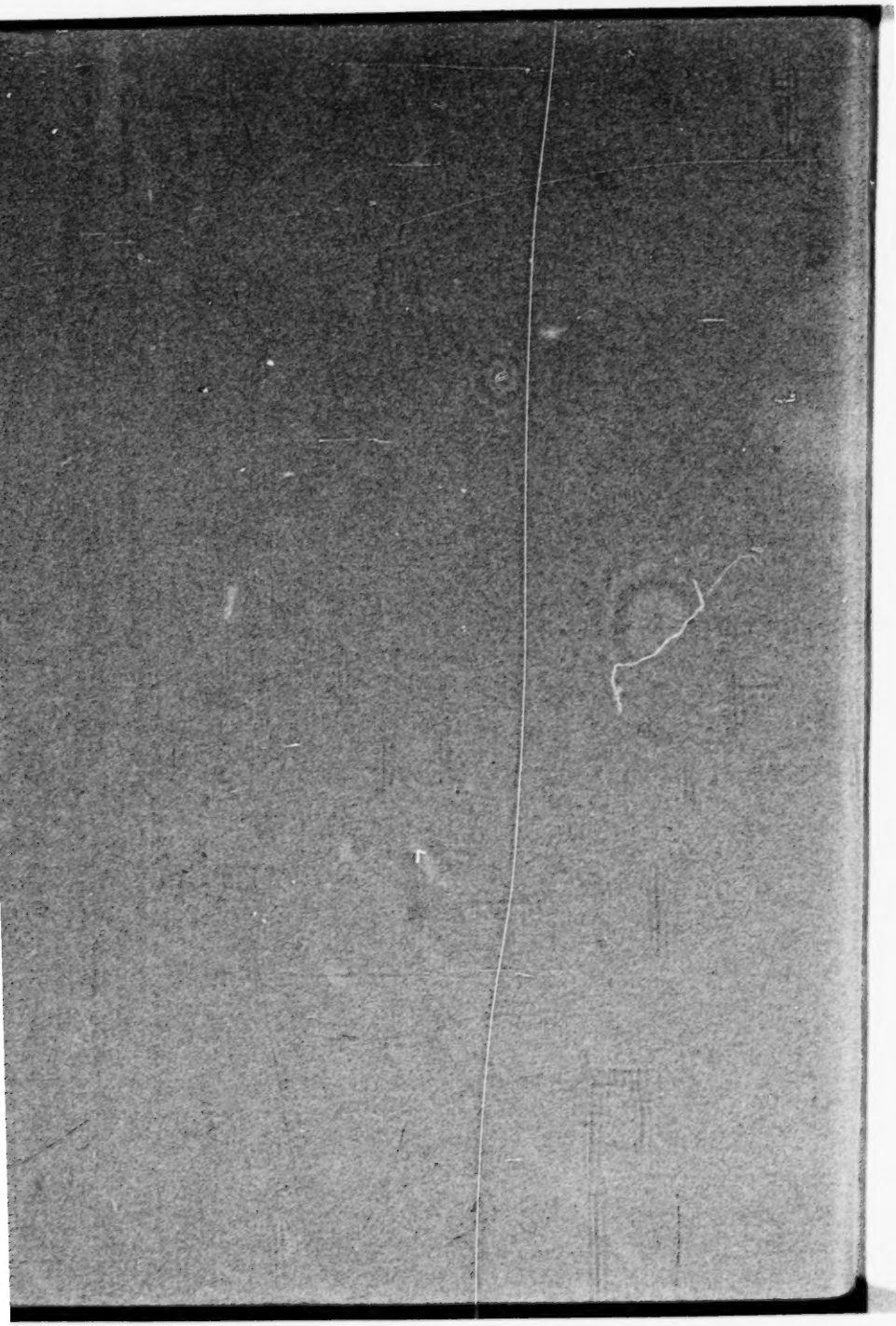
October 14, 1974.





APPENDIX A.

Opinion of the United States District Court, Central District of California.

United States District Court, Central District of California.

Community Bank, California Republic Bank, American Pacific State Bank, Coast Bank, Savings Bank of Mendocino County, Valencia Bank, The Bank of Downey, The Westlands Bank, Bank of Upper Lake, Mother Lode Bank, First City Bank of Rosemead, Shasta County Bank, Hacienda Bank, Cerritos Valley Bank, Independence Bank, Napa Valley Bank, Century Bank, The Bank of Finance, El Camino Bank, The County Bank, Bank of Rio Vista, California Pacific Bank, Bank of Loleta, Golden State Bank, Southwest Bank, First State Bank of Southern California, Home Bank, and Santiago Commercial Bank, Plaintiffs, v. Federal Reserve Bank of San Francisco, and Board of Governors of The Federal Reserve System, Defendants. No. 72-2220-MML.

Memorandum Opinion

Filed: February 8, 1973.

Plaintiffs, California State banks, filed a complaint under the Federal Reserve Act, 12 U.S.C. 221 et seq., seeking an injunction against the application of amended Regulation J, 37 Fed. Reg. 12714-12715 (1972), which defendant Board of Governors (Board) had declared effective as of September 21, 1972. Jurisdiction was asserted under 28 U.S.C. 1331(a). The Court accepted the Board's assurance of voluntary abstention in the application of said effective date pending a full hearing on the application for preliminary relief. The application for a preliminary injunction was denied on

October 10, 1972. Subsequently, both parties filed motions for summary judgment under Rule 56, Fed. R. Civ. Proc.

I

This case involves the Board's response to contemporary challenges to the present check collection system utilized in banking practices, and the effect of this response upon plaintiffs as State banks, not associated with the Federal Reserve System (Fed.). The check collection system presently utilized, and the effect of amended Regulation J, and its sister, amended Regulation D, 37 Fed. Reg. 12713-12714 (1972), upon that system, were fully discussed in the pleadings. The following is a summary of that system, and of the effect of the two proposed regulations upon that system.

The present check collection system involves two broad classes of banks—those directly participating with clearinghouse banks, and those not associated with clearinghouse banks. Most of the former are quite large and are associated with the Fed, while most of the latter are smaller, and may or may not belong to the Fed. The banks in the second class generally deposit their checks for collection with clearinghouse banks, though some of these banks which belong to the Fed deposit their checks directly with their Reserve Bank. The clearinghouse banks treat checks received for collection in the same manner that they treat checks received from other customers. Checks drawn on their own bank are segregated from checks drawn on other banks. The latter are called "transit" items, and are sorted according to collection method, which is determined by bank location, volume, and dollar value of items drawn, transportation schedules, and cut-off times for "same-day" handling set by the Fed and

commercial banks. Checks drawn on other banks in the same metropolitan area are usually cleared through a local clearinghouse bank providing daily exchanges of checks between participating banks. The clearinghouse banks usually settle each day by instructing the Reserve Bank to debit or credit the respective bank's reserve accounts. Checks drawn on the smaller banks are sometimes deposited for collection with their Reserve Bank, and sometimes with their correspondent banks (large clearinghouse banks which provide services for the smaller banks).

An increasing number of checks are presently being cleared through "regional check processing centers" (RCPC's) sponsored by the Fed, which clear checks for all banks, member and nonmember, within a regional metropolitan radius of sixty miles. The RCPC's are an important innovation, and are deemed to be a critical interim solution to the dilemma confronting the nation's payment system during the next decade. Of the approximately twenty-five billion checks to be collected on all banks during 1972, roughly one-third, or eight billion, will have been handled by the Fed. To handle this volume, the Fed, and other large correspondent banks, have resorted to the use of computer-controlled, high-speed sorters which are capable of handling 1000 checks per minute.

When these checks are presented for collection to a Reserve Bank by a member bank payment is made on a deferred basis. With one exception, the payment schedule is based upon the amount of time usually required for the Fed to collect items of a similar type, for example, "same day" items for checks drawn on banks in the same city (if received early in the day); "one-day" items for checks drawn on banks in other

cities with Fed offices; and "two-day" items for checks drawn on banks located in the same Fed "territory," but located outside of the Fed office city. However, the exception to this established schedule of a "two-day" maximum credit occurs when collection is to be made on checks drawn on banks in other Fed districts which, at the present time, requires a total of three days of processing, transmitting, and reception of remittance. "Float" is generated when a Reserve Bank pays for a check (on the deferment schedule) before that check is actually collected, in effect creating a "loan" to the payor bank involved. The combined effect of the new regulations purportedly would alleviate this problem of "time-schedule float."

Currently, all clearinghouse banks arrange "provisional" settlement of items by which their reserve accounts are debited to pay for checks on the day of receipt. Previously, "provisional" settlement was accomplished by dispatching bank drafts on the day checks were received, which drafts were received the following day under the deferred payment basis. Presently, most banks arrange such settlement by charging their reserve accounts at their member correspondent banks, but such charges are usually made on the day following presentment to coincide with the day of payment by the banks that still pay by draft. The gap between "provisional" and "final" settlement exists to provide examination of checks to determine fund sufficiency, stop payment orders, or other reasons for nonrecognition of checks. Regulation J, as amended, would require all banks to com-

plete "provisional" payment such that the funds would become *immediately available* to the Reserve Banks on the same day the checks are received. In response, also on that same day, the Reserve Banks would pass credit for the checks.

Thus, in essence, Regulation J, as amended, is an attempt by the Board to provide administrative controls for the on-going transition between the existing physical transfer-oriented payments system and the future computer-oriented payments network wholly based upon the widespread use of "electronic fund transfers" as substitutes for checks (transmission of a fund transfer order would be accomplished by the usage of "Magnetic Ink Character Recognition" unit's [MICR's] on individual checks in conjunction with electronic communication facilities). Regulation D, as amended, would complement this system by allowing members of the Fed to reduce their reserve requirements proportionately, thus allowing the members to meet the daily outflow demands of the "same-day" payment system. The Board concluded that through the full technological utilization of such facilities the nation's banking system could accommodate the estimated forty billion fund transfers anticipated by 1980. "Same-day" check payment was deemed necessary by the Board to achieve the transition, yet to maintain the viability of the present collection system for two principal reasons: (1) the basic unit of time upon which is calculated the productive value of money is one day; and (2) the expanding use of "electronic fund transfers" over an

extended period of time, coupled with the ever increasing volume of payments, requires that the present check collection system keep apace of the increased velocity until fully replaced.

II

Two broad issues were presented by the parties' motions for summary judgment:

(1) whether Regulation J, as amended, is contrary to California law, specifically, Cal. Comm. Code, §§ 4103, 4211, and 4302 (West 1964); and,

(2) whether Regulation J, as amended, is ultra vires, or otherwise invalid as an improper exercise of regulatory power by the Board.

Several subissues developed, which will be treated seriatum.

III

Plaintiffs' argument that the new Regulation J is contrary to California law is essentially two-pronged: (1) Regulation J would require payor banks to settle for demand items presented at the close of the banking day of receipt when the statute allows payor banks to defer provisional payment for one to two days; and (2) Regulation J would remove the Fed's option as collecting banks to take bank drafts in settlement when the statute authorizes collecting banks to accept such bank drafts.

The deferring of provisional payment for one to two days appears to have been merely a privilege derived from the operating procedure of the various Reserve Banks pursuant to former section 210.16 of Regulation J. 12 C.F.R. §210.16 (1972). As a matter of law, the statute provides that upon presentment of a demand

item, the bank becomes "accountable" if it retains that item beyond midnight of the banking day of receipt without settlement, or, irrespective of whether it is also the depository bank, if it fails to pay or return the item, or send notice of dishonor until after its midnight deadline. Cal. Comm. Code, §4302(a) (West 1964). Under amended section 210.9(a) of Regulation J, the payor bank would become accountable if it retains the item beyond the close of its banking day of receipt. 37 Fed. Reg. 12714 (1972). This advance of the deadline from midnight of the banking day to the close of business of the banking day of receipt appears to be in compliance with the Code.

The accountability provisions of section 4302 are subject to the variation by agreement section, Cal. Comm. Code, §4103 (West 1964), providing in part that the provisions of the bank deposits and collections' division may be varied by agreement, with certain exceptions not pertinent, and that regulations issued by the Board have the effect of agreements, "whether or not specifically assented to by all parties interested in items handled." Cal. Comm. Code, §4103(2) (West 1964). The Code further provides that specification, or approval of certain procedures does not constitute disapproval of other procedures "which may be reasonable under the circumstances." Cal. Comm. Code, §4103(4) (West 1964). Accordingly, "approval" of a midnight deadline is not tantamount to "disapproval" of a close of banking day of receipt deadline. The flexibility in this approach, and the approval of improved methods in check collecting procedures, is strongly suggested by the official comment to section 4103. Accordingly, the Court concludes that not only is section 4302 not immune from variation by the Board's regulations, but

that the Code has anticipated such check collection reforms by expressly sanctioning flexibility in methods of operation and by avoiding rigid guidelines in this area.

Plaintiffs' next contention is that California law requires the Fed to accept bank drafts in settlement of checks. The statutory source provides for optional forms of settlement for collecting banks, including the acceptance of checks drawn on other banks. Cal. Comm. Code, §4211(1)(a) (West 1964). Plaintiffs' position is that section 4211, and the entire scheme of the Code, emphasizes settlement as a two-way proposition—that the Code was designed for the convenience of both the payor and the collecting bank. However, the thrust of the official comment to section 4211 (*see* paragraph one) is that the alternatives for settlement were designed to alleviate the problem of the recipient bank, to ease the problems of volume and flow in the manner it saw fit. The argument advanced that, in some fashion, the Fed, as a group of collecting banks, is under some duty to accept bank drafts, or must at least voluntarily assume a share of the burden of collection, is not borne out by the implicit purpose of the section itself, or by the official comment.

Accordingly, the Court concludes that Regulation J, as amended, would not operate contrary to California law.

IV

Plaintiffs have submitted sweeping arguments attacking the very basis for the Board's authority in issuing the amendment to Regulation J. These arguments raise two substantial subissues: (1) whether Regulation J, as amended, is invalid on its face for abuse of discretion by the Board in exceeding the duties delegated

by Congress; and (2) whether Regulation J, as amended, is invalid in its application to pay nonmember banks insofar as it requires involuntary compliance by institutions not associated with the Fed.[1]

The first question raises judicial review under the Administrative Procedure Act, 5 U.S.C. 701-706. The Act allows judicial review except where "statutes preclude judicial review," or where "agency action is committed to agency discretion by law." 5 U.S.C. 701(a)(1) and (a)(2). Thus, review is excluded by implication and by express exclusion. There is no express exclusion of judicial review within the Federal Reserve Act, 12 U.S.C. 221 et seq. thus, the question turns upon whether the Board's action in this case is "committed to agency discretion by law."

Professor Davis emphasizes that "practical interpretation" of the Act, which will implement its probable intent, and which will produce sound substantive results, as that interpretation which emphasizes the term "committed." Thus, "[s]o far as the action is by law 'committed' to agency discretion, it is not reviewable—even for arbitrariness or abuse of discretion; it is not 'committed' to agency discretion to the extent that it is reviewable." 4 Davis, Administrative Law 80 (1958).

Panama Canal Company v. Grace Line, 356 U.S. 309 (1958) supports this interpretation. There the Court held that the controversy was "not one appropriate for judicial action" where the conflict concerned "problems of statutory construction and cost accounting" over readjustment of the Panama Canal tolls, a matter which the Court concluded Congress had left to the discretion of the Company. 356 U.S. at 317.

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[1]*See* Appendix A.

Similarly, in the instant case, it would appear that analogous "problems of statutory construction" and monetary controls are presented, to wit: whether an innovation in the check collecting mechanism of the Federal Reserve Banks is a "legitimate" exercise of the Board's statutory authority in making "all rules and regulations necessary" to enable it to effectively perform its duties, functions and services. *See* 12 U.S.C. 248(i). These indeed, appear to be "matters on which experts may disagree; they involve nice issues of judgment and choice." 356 U.S. at 317. They seem to require the inference that "the decision to act or not to act is left to the expertise of the agency burdened with the responsibility for decision." 356 U.S. at 318.

Judicial nonreviewability may also be "strongly" indicated by the "absence in any specific area of any kind of provision for judicial participation." *Schilling v. Rogers*, 363 U.S. 666, 674 (1960). As noted previously, an examination of the Federal Reserve Act discloses no provision for judicial participation with respect to any decisions of the Board. Of some significance to the contrary, Congress provided for full annual reports of the Board's operations to the Speaker of the House. The inference might be drawn that Congress sought direct accountability of the Board's policies to the legislative branch, rather than through interpretation by the courts. *See* 12 U.S.C. 247.

The Ninth Circuit relied upon *Panama Canal Company* in *Ferry v. Udall*, 336 F. 2d 706 (9th Cir., 1964) where it ruled that the Secretary of the Interior's determination that the appraisal value of certain lands had been understated in relation to a bid price was "committed" to his discretion, and thus was not reviewable under the Act. The Court noted that

"a decision of whether or not it would be in keeping with sound policy to sell a particular parcel of land at a certain offered price involves the exercise of informed discretion." 336 F. 2d at 712. A fortiori, a decision whether or not it would be consistent with sound monetary policy to amend the appropriate regulations governing check collection practices such that the velocity of money is affected so as to alleviate, inter alia, the problem of "float," and to afford an interim solution to the challenges of an expanded exchange system most certainly involves an "exercise of informed discretion." Accordingly, the Court concludes that the Board's action in amending Regulation J is not reviewable under section 10(a) of the Administrative Procedure Act, 5 U.S.C. 701(a).

Assuming, arguendo, that this Court has power to review the Board's amendment of Regulation J, it cannot conclude that the Board has exceeded or abused its discretionary powers. The scope of review is delineated by section 10(e) of the Act, which provides, inter alia, that a reviewing court shall "hold unlawful and set aside agency action, findings, and conclusions found to be . . . arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. 706(2)(A). Particular respect is accorded statutory interpretation by an administrative agency when the administrative practice at stake involves the " 'contemporaneous construction' " of a statute by those charged with the implementation, supervision, and maintenance of its regulatory machinery. *Udall v. Tallman*, 380 U.S. 1, 16 (1965).

More specifically,

> "Administrative action may be regarded as arbitrary and capricious only where it is not support-

able on any rational basis . . . 'something more than error is necessary to spell out arbitrary or capricious action.'" *Carlisle Paper Box Company v. N.L.R.B.*, 398 F. 2d 1, 6 (3rd Cir., 1968).

Where abuse of discretion is raised, the court is obligated to recognize that, in a highly technical area, the evaluation of different data and alternatives (for example, the consideration of economic forces affected by national monetary policy) requires that the agency vested with such power (for example, the Federal Reserve Board) be given a wide latitude of discretion in the selection and assignment of weight to those various factors in arriving at its decisions. *See Nadiak v. C.A.B.*, 305 F. 2d 588, 593 (5th Cir., 1962).

The record in this case clearly reflects a comprehensive and thorough information-gathering and opinion-soliciting administrative process by which the Board initiated its rule-making procedures, and implemented them subject to on-going modification by critiques from those interest groups most intimately affected. Accordingly, the Court cannot conclude that the Board acted with insufficient factual data, with inadequate attention to the natural and probable consequences of its decisions, or with disregard to the suggestions and recommendations of those persons concerned. There is no question that the Board did not act arbitrarily, or capriciously, or that it did not abuse its discretion in issuing amended Regulation J.

V

Plaintiffs also contend that the Board acted in excess of its statutory authority in further violation of section 10(e) of the Act, 5 U.S.C. 706(2)(C). In support of this contention, plaintiffs cite *Farmers' & Merchants'*

Bank v. Federal Reserve Bank, 262 U.S. 649 (1923). In that case, the Supreme Court held invalid an attempt by the Board to eliminate a State bank practice of deducting small charges ("exchanges") from the sum of remitted funds, and to impose a universal par clearance and check collection system through Reserve Banks. In reaction to this attempt, the North Carolina legislature had enacted the statute under challenge, which provided that, unless the drawer indicated on the face of the check that he required payment in cash, the drawee bank was at liberty to pay the check by exchange drawn on its reserve deposits. The statute gave the drawee bank the option to pay by exchange only in certain instances when the check was presented by or through any Reserve Bank, or any respective agent thereof.

> The option was so limited, because the only purpose of the statute was to relieve state banks from the pressure which, by reason of the common-law requirement, Federal Reserve Banks were in a position to exert and thus compel submission to par clearance. 262 U.S. at 659.

The question presented to the Supreme Court raised the constitutionality of the North Carolina statute on five different theories. The first four theories do not concern the instant case. The fifth theory presented the argument which most strongly assailed the validity of the State law, to wit: whether it conflicted with the Federal Reserve Act because it interfered with the duties of the Board in establishing a "universal system of par clearance and collection of checks." 262 U.S. at 664. The Supreme Court concluded that sections 13 and 16 of the Act (*see* 12 U.S.C. 342 and 360) in

no manner, expressly or implicitly, referred to nonmember banks with respect to the process of check collection at issue. The Court also viewed the contention that Congress had imposed a duty upon the Board of establishing universal par clearance and check collection as "irreconcilable" with the Hardwick Amendment (a proviso relating to exchanges added in the Senate) which declared that "even a member or an affiliated nonmember may make a limited charge" (except to Reserve Banks) for payment of checks by exchange or otherwise. 262 U.S. at 666. Thus, such a duty never being intended by Congress, the power of the Board was limited accordingly. The court found that the Hardwick Amendment in no manner interfered with the right of a depositor in a nonaffiliated State bank to agree that the checks drawn on him might be payable, at the option of the drawee bank under State law, in exchange in certain instances. *See* 262 U.S. at 667.

Thus, the question at this juncture is whether the effect of Regulation J, as amended, will impose upon plaintiff State banks an analogous nationwide check clearance system similar to the one struck down by the Supreme Court in *Farmers' & Merchants' Bank*.

The facts as established suggest that such is not the case, since plaintiffs do have a choice of whether or not to consent to have checks drawn on them presented for collection through the Fed. However, plaintiffs pose the following provocative question: whether the participation by plaintiff nonmember banks in the Fed's check collection system, as altered by amended Regulation J, will be "voluntary," and whether such "voluntary" participation is contrary to the purposes of State bank functioning vis-a-vis the Reserve Bank System.

The strength of plaintiffs' argument stems from the two sanctions available to the Fed to enforce amended Regulation J: (1) requiring accountability by the payor bank if settlement is not achieved at the close of the day of business, or at an earlier time as allowed, 37 Fed. Reg. 12714 (1972); and, (2) charging back the item to the sender regardless of whether or not the item itself can be returned if the Reserve Bank does not receive the earlier payment as required, 37 Fed. Reg. 12714-12715 (1972). Two points should be discussed: (1) the various methods generally available for check collection; and (2) the check collection procedure available through correspondent banks.

Plaintiffs gloss over the fact that other mechanisms are available in the check collection system. "*Direct sending*" is available by which any bank handling an item for collection, except the payor bank, may send "[a]ny item direct to the payor bank." Cal. Comm. Code, §4204(2)(a) (West 1964). Thus, a bank may send a deposited check *directly* to the payor bank without utilizing the services of intermediary correspondent banks. *Direct depositing* is available by which checks drawn on the payor banks are directly deposited in that paying bank—thus, no collection channels involving intermediaries are involved. (According to one study, of the approximately twenty-one billion checks written during 1970, six billon were direct deposits, and six and one-half billion went through Reserve Banks. Thus, the majority of checks collected, some nine billion, were negotiated through commercial banks, not through the Fed. *See* American Banking Association, The Outlook for the Nation's Check Payment System (Arthur D. Little, Inc., 1970). Plaintiff takes issue with this interpretation, suggesting an in-

direct effect which is treated hereafter.) Finally, *nonpar checks* are *not* collected through the Fed (checks which are not collectible at their face value). Some banks utilize the nonpar method, and such banks are not allowed to send checks directly, or through correspondent member banks, to the Fed for collection, nor will the latter present checks drawn on a nonpar bank to such bank.[2] The existence of these alternatives as real choices, albeit economically consequential, requires the conclusion that the system remains as essentially "voluntary," and is not the equivalent of a universal check clearing system.

VI

Stemming from the above argument, plaintiffs next contend that because of their use of the collection services of correspondent banks, and because of the combined impact of Regulation J in conjunction with Regulation D, they will be deprived of the full use of their reserve funds, and thus placed at a great disadvantage with respect to member banks—the end result of which is coerced association with the Fed. Briefly, the argument is that the correspondent banks actually perform two services for plaintiffs: (1) the accounts maintained at these banks by the plaintiff State banks exist as a source of compensation for the collection services rendered by these banks; and (2) the accounts maintained also exist as the requisite reserve requirement which the plaintiffs are required by California law to maintain (the reserves *may* be maintained in such fashion at commercial banks). In order for the account to be so maintained as a source of compensation for the correspondent banks, it must be of sufficient size to make

[2] *See* Appendix B.

investment a profitable venture. (If the account's earning capabilities are exceeded by the collection costs, then it is unprofitable, and the correspondent bank must request an appropriate increase in the account.) However, the California banks must also meet the minimum reserve amount as required by law. Regulation J's "same-day" remittance requirement would deprive those banks presently affected of approximately $2 billion in reserve assets. To compensate for this effect, Regulation D would authorize the release of $3.5 billion in reserves, thus making a net release of $1.5 billion as surplus liquidity.

This, of course, would only concern member banks —the California State banks would not gain any benefit from Regulation D. Hence, the California Superintendent of Banks has announced his intention to reduce the reserve requirements for California State banks to offset the reserve loss of those banks required to meet the "same-day" requirements for checks collected through the Fed. *See* Cal. Finan. Code, §1257 (West 1968). But plaintiffs argue, this State-authorized reduction of reserves squarely conflicts with the privately-negotiated minimum account agreement with the correspondent banks in order to meet their investment requirements. Thus, if the latter, through market realities, is required to be larger than the former, through statutory assistance, then the California State banks acquire no compensatory benefit whatsoever from the State action of reducing reserve requirements, and they are unable to recoup as a result.

This is a crucial point of departure for plaintiffs' case, for it takes leave of the arena of strict legal duties and rights, and dovetails with the realm of economic cause and effect. The question thus becomes at what

point does the Board's exercise of its regulatory powers depart from the mere role of technical application authorized by the Federal Reserve Act, and become one of improper tampering with the dual banking system presently sanctioned by law, and currently engendered by market forces in the United States. This is not a fertile area of the law.

However, the evidence presented in this case is not such that this Court can quite conclude that the Board has instituted its regulatory powers to compel plaintiff banks to join the Fed, or to otherwise oppress or injure plaintiff California State banks. As the Supreme Court at once phrased and resolved the issue:

> Country banks are not entitled to protection against legitimate competition. Their loss here shown is of the kind to which business concerns are commonly subjected when improved facilities are introduced by others, or a more efficient competitor enters the field. It is damnum absque injuria. *American Bank & Trust Co. v. Federal Reserve Bank*, 262 U.S. 643, 648 (1923).

An appropriate footnote to that statement might be that such banks are also not entitled to forestall the progress engendered by the introduction of such improvements, particularly where the majority stands to benefit, ultimately, a great gain.

VII

Accordingly, this Court concludes that the effect of Regulation J, as amended, coupled with the amended complementary measure, Regulation D, upon plaintiff

California State banks, which effect will substantially challenge their present procedures of check collection and of meeting reserve requirements, is not such that legal protection can be gathered from the Federal Reserve Act; rather its impact lies predominately within the sphere of improved techniques and facilities available from present technology, and thus lies without the definition of an injury at law.

IT IS THEREFORE ORDERED, that plaintiffs' motion for summary judgment is denied; that defendants' motion for summary judgment is granted; and that each party shall bear its own costs as incurred.

IT IS FURTHER ORDERED that the Clerk of this Court serve copies of this Memorandum Opinion upon all respective counsel of record. Date: February 5, 1973.

/s/ Malcolm M. Lucas
Malcolm M. Lucas
United States District Judge

The latter subissue raises collateral questions which, although not controlling in this case, should be given at least passing recognition. In *Peoples Bank v. Federal Reserve Bank of San Francisco*, 58 F. Supp. 25 (N.D. Calif., 1944), appeal dismissed, 149 F. 2d 850 (1945), and in *Peoples Bank v. Eccles*, 64 F. Supp. 811 (D.D.C., 1946), *rev'd* 161 F. 2d 636 (1947), *rev'd* 333 U.S. 426 (1948), *rehearing denied* 333 U.S. 877 (1948), plaintiff California State bank sought an injunction to restrain the enforcement of a condition to membership in the Fed required by the Board. The merits were not reached in the Northern District of California case, dismissal being granted under Rule 12(b)(2), Fed. R. Civ. Proc. as to the Board, and under Rule 12(b)(6), Fed. R. Civ. Proc. as to the Reserve Bank. (In the instant case, the former defense as to the Board was waived.) In the District of Columbia case, the merits were considered, the Court finding that a justiciable controversy existed under the Declaratory Judgment Act, and recognizing the possibility of judicial nonreviewability although not passing on that particular question. The case was reversed on the view that the Board had exceeded its administrative discretion in its "assumption of the power to check the expansion of bank holding companies." 161 F. 2d at 640. The Supreme Court, in reversing, based its decision on the total record available, including testimony before the House Committee on Banking and Currency. The Court deemed the bank's grievance "too remote and

insubstantial, too speculative in nature, to justify an injunction," and "therefore, equally inappropriate for a declaration of rights." 333 U.S. at 434. Thus, the Supreme Court failed to pass upon the lower courts' differing conclusions as to the reach of the Board's authority under the Federal Reserve Act, and therefore, those cases afford no unequivocal, nor undisturbed, interpretations of controlling significance.

APPENDIX B

Nonpar checks are distinguished from checks drawn on Reserve Banks by the absence on the former of a routing symbol in the upper right-hand corner of the check, and by the presence on the former of a number "9" before the "MICR number," *see* discussion, *supra*, located on the lower left-hand corner of the check, which number indicates that the check may not be sent through the Fed for collection. The presence and/*or* absence of these symbols (apparently both conditions must be met for exclusion) constitute consent to processing through the Fed. Plaintiffs take issue with the fact that for them to avail themselves of the nonpar option, they will have to recode their "ABA Routing Number" (assigned to all banks by the American Banking Association, with modifications for Federal Reserve Districts) since the use of the "number" presently assigned constitutes "voluntary" acquiescenses to processing by the Fed. Thus, the argument would be that such banks should not have to conform with the Fed when, by the defendants own admission, only about 30% of all checks are collected through the Fed. However, this

argument carries weight only in response to the option available for nonpar banks. Plaintiffs still may retain the par system (thus avoiding this "volitional"-"voluntary" contradiction) yet utilize "direct sending" as a means of avoiding the Fed. Of course, this means a less efficient method of check collection outside of the Fed, but that begs the very question of this action: whether the Board's attempts to enhance the efficiency of the Fed check collection system with respect to those banks desirous of participation in that system constitute any basis for legal injury for those banks wishing to avoid that option. There is nothing in the Federal Reserve Act which precludes the Board from adopting new measures which make it unattractive from an economic point of view for banks to remain outside of the Fed's check collection system. *See* discussion, *infra*.

APPENDIX B.

Opinion of the United States Court of Appeals for the Ninth Circuit.

United States Court of Appeals, for the Ninth Circuit.

Community Bank, et al., *Appellants,* vs. Federal Reserve Bank of San Francisco, and Board of Governors of the Federal Reserve System, *Appellees.* No. 73-1808.

OPINION

[July 22, 1974].

On Appeal from the United States District Court, for the Central District of California.

Before: TRASK and SNEED, Circuit Judges, and POWELL,* District Judge.

SNEED, Circuit Judge:

On June 21, 1972, the Board of Governors of the Federal Reserve System unanimously approved changes in Regulation J, 12 C.F.R. §210, which governs the collection of checks and other items by Federal Reserve Banks. Appellant State Banks, who are neither members of nor affiliated with the Federal Reserve System, object to the amendments to Regulation J insofar as they affect nonmember and non-affiliated payor banks.

Briefly stated, the changes in Regulation J affect both the *time* and *manner* in which payor banks must settle for demand items presented for collection by Reserve Banks. Prior to the amendments, payor banks became accountable if they failed to settle for demand items before midnight of the banking day of receipt, and set-

*Honorable Charles L. Powell, Senior Judge, Eastern District of Washington, sitting by designation.

tlements made earlier could be revoked prior to the midnight deadline. The amendments to Regulation J advance the settlement *time* to the *close* of the banking day of receipt, and only if settlement is made prior to this time may it be revoked before midnight of the banking day of receipt. The amendments also affect the *manner* in which settlement may be made by eliminating drafts drawn on other banks as permissible forms of settlement.[1]

Appellants attack the amendments to Regulation J on two broad grounds. First, they urge that the changes are inconsistent with the time and manner of settlement provisions contained in the *California Commercial Code*, which they contend should govern the operations of nonmember banks chartered under the laws of the State of California. Second, they argue that, to the extent that they attempt to bind payor banks which are not members of the Federal Reserve System, the amendments to Regulation J exceed the power conferred on the Board under the Federal Reserve Act.

Appellant State Banks' application for a preliminary injunction was denied by the district court on October 10, 1972, and on February 8, 1973, the court entered summary judgment in favor of appellees. We affirm.

Our consideration of the issues presented in this appeal will begin with a brief description of the check collection process and the effects of the amendments to Regulation J on this process. We will then turn to a more detailed examination of the provisions of the *California Commercial Code* and Regulation J to determine if the amendments to the regulation give rise to a fed-

[1]Prior to the amendments, the time and manner of settlement provisions of Regulation J and the California Commercial Code were virtually identical.

eral-state conflict in the area of banking regulation. Finally, finding no such conflict, we will consider whether Regulation J as amended exceeds the scope of authority conferred on the Board by the Federal Reserve Act.

I.

Background

Approximately 25 billion checks were collected by banks in 1972; of these, eight billion, or roughly one-third, were handled by Federal Reserve Banks. The Reserve Banks provide check collection services for member banks and affiliated nonmember banks which maintain a certain balance with a Reserve Bank;[2] neither the members nor the affiliated nonmembers, however, are required to use the services of the Reserve Banks to collect checks which have been presented to them.

To handle the increased volume of checks, Federal Reserve and other large banks now use computer-controlled, highspeed electronic sorters which are capable of handling 1000 checks per minute. For this purpose, "Magnetic Ink Character Recognition" (MICR) units are pre-printed on each check. The first group of four digits in the MICR number encoded on the bottom of each check designates the Federal Reserve district, territory, and relationship to the local Federal Reserve office.[3] Each of the appellant State Banks encode their checks with a MICR number that begins with "12", which indicates that they are located in the district of the Federal Reserve Bank of San Francisco. The consequence of this is that checks which are drawn

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[2] *See* 12 U.S.C. §342.

[3] In addition, the numerator of the fraction located on the upper right-hand portion of appellants' checks represents the Federal Reserve routing number.

on appellants may be presented by a member or affiliated nonmember bank for collection through the Federal Reserve system.

When checks are presented to a Reserve Bank for collection, settlement is made on the basis of a deferred-payment schedule. This schedule is, with one important exception, based on the amount of time usually required for the Reserve Bank to collect items of a similar type. Since checks drawn on banks in the same city may usually be collected on the same day, same-day credit is passed to the depositor. Checks drawn on banks in other cities having Federal Reserve offices may usually be collected the following day; accordingly, one-day credit is passed to the depositor. Two-day credit is passed when the check is drawn on banks located within the same Federal Reserve territory but outside of a Reserve office city. The exception exists because, while three days may be required to collect checks drawn on banks outside of the Reserve territory and not located in an office city,[4] two-day credit is the maximum length of deferment for any check presented to a Reserve Bank for collection.[5] Thus, in this latter situation the Reserve Bank pays for a check on the basis of the deferred-payment schedule one day before that check is actually collected; this effectively generates a one-day, interest-free loan to the bank involved. The total amount of such loans is known as Federal Reserve "float". Aggravating the problem of delay in the proc-

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[4]The three days include: (1) one day to process the item at the Reserve Bank of first receipt and transmit it to the Reserve Bank for the area in which the payor bank is located; (2) one day for the item to be processed by the second Reserve Bank and transmitted to the payor bank; and (3) one additional day to receive the remittance.

[5]Federal Reserve Operating Circular No. 1.

ess of settlement is the practice of some payor banks to settle by means of drafts drawn on other banks.[6]

To alleviate these problems, the amendments to Regulation J (1) advance the time within which payor banks must settle for checks presented for collection by Reserve Banks, and (2) eliminate the use of bank drafts as permissible forms of settlement by requiring settlement to be in immediately-available funds. The resulting acceleration of the process, in turn, enables the Reserve Bank in some instances to pass earlier credit to the depositor bank. From the vantage point of the Federal Reserve, the changes are particularly desirable in that they tend to reduce the problem of "float."[7]

II.

State Law

We now turn to a consideration of whether the amendments to Regulation J are, as the appellants insist, in conflict with the pertinent provisions of the *California Commercial Code*.

A. Time of Settlement

Two principal *California Commercial Code*[8] provisions governing the time in which a payor bank must

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[6]A draft on the remitting bank itself is not permissible because it would merely substitute for the original item another item on the same payor. California Commercial Code §4211(a).

[7]The elimination of float, which approximates $2 billion a year, causes a comparable loss of reserves for those banks enjoying the deferred-payment aspects of this system. To ease this blow, the Board amended Regulation D, 12 C.F.R. §204, to permit members of the Federal Reserve to reduce their reserve requirements proportionately. Although the lowering of reserve requirements does not benefit nonmember appellants, the California Superintendent of Banks has announced his intention to reduce the reserve requirements applicable to the State Banks in order to offset the same-day requirements for checks collected through the Federal Reserve System.

[8]Unless otherwise indicated, all citations are to provisions of the California Commercial Code.

settle when presented with a check for collection are affected by the amendments to Regulation J. Section 4302[9] makes a payor bank accountable if it retains an item beyond midnight of the banking day of receipt without settling for it, and Section 4301[10] allows the payor banks to revoke a provisional settlement if such revocation is made before the midnight deadline.[11] Sec-

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[9]Section 4302 provides, *inter alia:*

> In the absence of a valid defense such as breach of a presentment warranty (subdivision [1] of Section 4207), settlement effected or the like, if an item is presented on and received by a payor bank the bank is accountable for the amount of
>
> (a) A demand item other than a documentary draft whether properly payable or not if the bank, in any case where it is not also the depositary bank, retains the item beyond midnight of the banking day of receipt without settling for it or, regardless of whether it is also the depositary bank, does not pay or return the item or send notice of dishonor until after its midnight deadline; or
>
> . . . .

[10]Section 4301 provides, *inter alia:*

> (1) Where an authorized settlement for a demand item (other than a documentary draft) received by a payor bank otherwise than for immediate payment over the counter has been made before midnight of the banking day of receipt the payor bank may revoke the settlement and recover any payment if before it has made final payment (subdivision [1] of Section 4213) and before its midnight deadline it
>
> (a) Returns the item; or
>
> (b) Sends written notice of dishonor or nonpayment if the item is held for protest or is otherwise unavailable for return.
>
> (2) If a demand item is received by a payor bank for credit on its books it may return such item or send notice of dishonor and may revoke any credit given or recover the amount thereof withdrawn by its customer, if it acts within the time limit and in the manner specified in the preceding subdivision.
>
> . . . .

[11]Section 4104 of the Commercial Code provides:

> (c) 'Banking day' means that part of any day on which a bank is open to the public for carrying on substantially all of its banking functions;
>
> . . . .

tion 210.9(a)(1) of the amended Regulation J, however, makes a payor bank accountable if it fails to settle for demand items before the close of its banking day of receipt, and Section 210.12(a) provides that only if settlement has been made by this time may the payor bank revoke prior to midnight of the banking day of receipt.

Taken this far, Regulation J quite obviously is in conflict with the above provisions of state law. The conflict disappears, however, in light of the flexibility provided in Section 4103 of the *Commercial Code*. Subsection (1) of this provision permits variation of the Code's provisions by agreement, and subsection (2) provides that "Federal Reserve regulations and operating letters, clearing house rules, and the like, have the effect of agreements . . . whether or not specifically assented to by all parties interested in the items handled."

Appellants contend that Section 4103(2) does not operate to make Federal Reserve regulations binding on nonmember, payor banks. We disagree. The legislative history behind the language of subsection (2),

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(h) 'Midnight deadline' with respect to a bank is midnight on its next banking day following the banking day on which it receives the relevant item or notice or from which the time for taking action commences to run, which ever is later;

. . . .

Section 4107 provides:

(1) For the purpose of allowing time to process items, prove balances and make the necessary entries on its books to determine its position for the day, a bank may fix an afternoon hour of 2 p.m. or later as a cutoff hour for the handling of money and items and the making of entries on its books.

(2) Any item or deposit of money received on any day after a cutoff hour so fixed or after the close of the banking day may be treated as being received at the opening of the next day.

These provisions of the California Commercial Code are consistent with Section 210.9(a) of Regulation J, as amended.

which elevates Federal Reserve regulations to the status of agreements, "whether or not specifically assented to by all parties interested in the items handled," makes clear that it may be applicable to non-member payor banks. The *California Commercial Code Comment* indicates that, under prior California law, clearinghouse rules "did not govern the rights of a *drawer* and *payee* who were not members of the clearinghouse and who did not contract with express reference to those rules." (emphasis added). The reference to the rights of drawers and payees under "prior California law" suggests that the Code has changed this result. That this change effected by the Code is *not* limited to drawers and payees is indicated by the breadth of the following comment of the Senate Fact Finding Committee: "Subdivision 2 apparently changes the rule insofar as it applies between *parties* who are not members of the clearinghouse." (emphasis added). *Sixth Progress Report to the Legislature by the Senate Fact Finding Committee on the Judiciary: Part I, The Uniform Commercial Code 87.*

The Report of the New York Law Revision Commission contains an even stronger indication that Section 4103(2) is applicable to nonmember, payor banks which affiliate themselves with the Federal Reserve's check collection process:

> Federal Reserve Regulations and operating letters now operate as 'agreements' between the Federal Reserve Banks and banks using the Federal Reserve facilities for collection, and clearinghouse rules now operate of course as agreements among member banks and banks clearing through banks that are members of the clearinghouse association. *They are similarly effective as agreements binding on*

> *other banks, and their customers, whenever a claim* [sic] *of agency and subagency can be made out connecting the remote bank, and its customer, with the banks that are parties to the agreement,* and the agency includes, as a term of the agreement binding the remote party, the power to adhere to that agreement on behalf of the remote principal. Explicit agreement is sometimes difficult to spell out, however. Section 4103(2) postulates an implied assent as a rule of law. (emphasis added).

2 Report of the New York Law Revision Commission for 1955: Study of the Uniform Commercial Code 1262-63. The "claim of agency or subagency" referred to in the Report, which constitutes the necessary predicate for Federal Reserve regulations to be binding on nonmember banks, is readily established by the current voluntary use of MICR members [sic] by appellants.

As mentioned above, each of appellants encode their checks with the number "12". which indicates that they are located in the 12th Federal Reserve district. Obviously, if this number is merely removed, appellants' checks cannot be electronically processed. If, however, it is replaced by appropriate symbols, the checks may be electronically processed and collected *outside* of the Federal Reserve system.

That elimination of the Federal Reserve routing numbers is commercially feasible is demonstrated by the current practices of nonpar banks. Since Reserve Banks are prohibited by statute from paying an exchange fee, 12 U.S.C. §342, checks drawn on nonpar banks cannot be collected through the Federal Reserve system. Nonpar banks replace the Federal Reserve routing number on the lower left-hand portion of their checks with the

number "9". This enables the checks of nonpar banks to be electronically processed even though the MICR number begins with a "9" and even though it does not contain a number referring to any Federal Reserve office. A somewhat similar system as an alternative to the use of Federal Reserve routing numbers is available to appellants. The fact that nonmember banks may find it less commercially advantageous than utilizing the Federal Reserve routing number does not militate against this conclusion.

In sum, appellants are not required to include the Federal Reserve routing number on their checks, and so long as they continue to use this number, the "claim of agency or subagency" referred to in the Report of the New York Law Revision Commission exists, and the terms of Regulation J are binding upon them because of the operation of Section 4103(2).

B. Manner of Settlement

The asserted conflict between the amended Regulation J and Section 4211 of the *California Commercial Code* is also nonexistent.

Section 4211 lists six forms of remittance which "a collecting bank may take in settlement of an item."[12]

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[12]Section 4211 provides, inter alia:

(1) A collecting bank may take in settlement of an item
  (a) A check of the remitting bank or of another bank on any bank except the remitting bank; or
  (b) A cashier's check or similar primary obligation of a remitting bank which is a member of or clears through a member of the same clearinghouse or group as the collecting bank; or
  (c) Appropriate authority to charge an account of the remitting bank or of another bank with the collecting bank; or

The first of these, Section 4211(1)(a), is "a check of the remitting bank or of another bank or any bank except the remitting bank." Section 210.9(a) of Regulation J, however, provides that settlement shall be affected in one of three ways: (1) a debit to an account on the books of a Federal Reserve Bank; (2) payment in cash, or (3) at the discretion of the Federal Reserve Bank, any other form of remittance, provided that the proceeds of such payment are available to the Reserve Bank "not later than the close of the banking day for such Federal Reserve Bank on the day on which such item was so received by the paying bank." A check of the payor bank drawn on another bank would not be convertible into proceeds within the time limits set forth in Section 210.9(a) of the amended Regulation J; thus, Section 4211(1)(a) of the *Commercial Code* is no longer available as a means of settlement for checks cleared through the Federal Reserve system.

Appellants argue that Section 4211 treats settlement as a two-way proposition, and that it was designed for the convenience of *both* the payor and the collecting banks. From this, they conclude that the collecting bank, in this case the Federal Reserve, does not have the option of refusing to accept any of the six forms of settlement listed in Section 4211.

Those contentions are refuted by the background of and change effected by Section 4211. At common law,

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(d) If the item is drawn upon or payable by a person other than a bank, a cashier's check, certified check or other bank check or obligation; or

(e) Credit on the books of any federal reserve bank or of any bank designated as a depositary by the collecting bank; or

(f) Money.

. . . .

a collecting bank which accepted anything short of specie in settlement did so at its own risk.[13] As the *Uniform Commercial Code Comment* makes clear, the purpose of Section 4211 is to protect the collecting bank if it accepts something less than legal tender:

> Subsection (1) states various types of remittance instruments and authorities to charge which may be received by a collecting bank in a settlement for an item, without the collecting bank being responsible if such form of remittance is not itself paid . . . . Since it is not feasible for banks to perform their collection functions except with the use of these provisional remittances, they should not be penalized for acting in the only way they can act.

Thus, the thrust of Section 4211 is to alleviate the problems of the collecting bank in accepting in settlement various types of remittances. It was not designed to require a collecting bank to accept any one or all mentioned forms of remittances in settlement of items. Collecting banks *may*, with legal safety, accept any one of the mentioned forms. Whether they *will* accept a given form is a different issue, one to which the amended Regulation J is directed.

Thus, neither the time of settlement nor the manner of settlement provisions of Regulation J are contrary to California law.

III.

Federal Law

Finally, we turn to a consideration of whether the regulation is within the scope of authority conferred

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[13]*See generally New York Law Rev. Comm'n, supra* at 1355.

on the Board by the Federal Reserve Act. Appellants strongly contend that it is not.

The critical statutory provision dealing with the Federal Reserve's role in the check collection process is 12 U.S.C. §342, which provides:

> Any Federal reserve bank may receive from any of its member banks . . . checks, and drafts, payable upon presentation, and also, for collection, maturing notes and bills; or solely for purposes of exchange or of collection, may receive from other Federal reserve banks deposits of . . . checks upon other Federal reserve banks, and checks and drafts, payable upon presentation within its district . . . ; or, solely for the purposes of exchange or of collection, may receive from any nonmember bank or trust company deposits of . . . checks and drafts payable upon presentation . . . ; *Provided*, such nonmember bank or trust company maintains with the Federal reserve bank of its district a balance sufficient to offset the items in transit held for its account by the Federal reserve bank; . . . .

The authority of Reserve Banks under this section includes the power to collect checks drawn on nonmember banks. *See American Bank and Trust Co. v. Federal Reserve Bank of Atlanta*, 262 U.S. 643 (1923). The Board is also authorized to promulgate rules and regulations necessary to the performance of its functions. 12 U.S.C. §248(i). *See also* 12 U.S.C. §248(o).

The appellant State Banks heavily rest their contention on *Farmers and Merchants Bank of Monroe v. Federal Reserve Bank of Richmond*, 262 U.S. 649 (1923). The problem in *Farmers and Merchants Bank*

arose because of the practice of many nonmember and non-affiliated North Carolina State Banks to charge a fee when presented with a check for collection. This practice, also followed by certain banks in other states, is known as "no par clearance," and the Federal Reserve is prohibited by statute from paying such a fee. 12 U.S.C. §342. The Federal Reserve attempted to pressure the State Banks into accepting par clearance by presenting checks drawn on banks following no par practices over the counter for settlement in cash. The common law required that over the counter settlements be in cash. To remove this instrument from the hands of the Reserve, North Carolina enacted legislation providing that, unless the drawer indicated by notation on the face of the check that he required payment in cash, the payor bank was at liberty when the check was presented by a Federal Reserve Bank to pay the check by exchange drawn on its reserve deposits. The statute was thus clearly designed "to relieve state banks from the pressure which . . . Federal Reserve banks were in a position to exert and thus compel submission to par clearance." 262 U.S. at 659.

The Supreme Court sustained the North Carolina statute, and, for purposes of the present controversy, two points resolved in the opinion are significant. First, the Court rejected the Federal Reserve's argument that the state statute impaired the legitimate functions of the Federal Reserve in the area of check collection. The Court reasoned that, since the Act does not require the Federal Reserve to collect checks drawn on banks which follow no par practices, "[n]o duty or right of the federal reserve bank to collect checks is obstructed by the North Carolina statute which merely gives to the drawee bank the right to pay in the customary

exchange draft, where its depositor has, by the form used in drawing the check, consented that this be done." 262 U.S. at 664.

There is nothing in this that supports the appellants. The Court only recognized the right of a state to alter the common law rules relating to bank collections. Here we only recognize the right of the Federal Reserve to promulgate rules with respect to check collections in a manner countenanced by applicable state law. Neither the Federal Reserve here nor North Carolina in *Farmers and Merchants Bank* have acted beyond its power.

The Federal Reserve also argued that the North Carolina statute interfered with the duty of the Board to establish a *universal* system of par clearance and check collection. There can be little question that, if the Federal Reserve correctly perceived its role, the state statute would have been a serious impediment to the exercise of its responsibilities. The Court, however, flatly rejected the argument that the Federal Reserve Board was charged with the responsibility of establishing universal par clearance and collection of checks.

> Congress did not in terms confer upon the Federal Reserve Board or the federal reserve banks a duty to establish universal par clearance and collection of checks; and there is nothing in the original act or in any amendment from which such duty to compel its adoption may be inferred.

262 U.S. at 664.

Since the amendments to Regulation J do not, in our view, represent an attempt to establish a universal system of check clearance, appellants' reliance on *Farmers and Merchants Bank* is misplaced. Because the

State Banks are not required to use Federal Reserve routing numbers on their checks, and because alternatives exist to the use of such numbers, the system must be characterized as essentially voluntary. Under such circumstances, the amendments to Regulation J cannot be viewed as an attempt by the Board to establish a universal system of check collection. If the amended Regulation J proves too onerous to the State Banks, they are free to remove themselves from the system.[14]

The amendments to Regulation J are both consistent with California law and within the power conferred on the Board by the Federal Reserve Act. The judgment of the district court, is therefore, affirmed.

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[14] *Compare* American Bank & Trust Co. v. Federal Reserve Bank, 262 U.S. 643, 648 (1923):

> Country Banks are not entitled to protection against legitimate competition. Their loss here shown is of the kind of which business concerns are commonly subjected when improved facilities are introduced by others, or a more efficient competitor enters the field. It is damnum absque injuris.

APPENDIX C.

Relevant Provisions of the Federal Reserve Act, 12 U.S.C. §§221, Et Seq.

§248(i) To require bonds of Federal reserve agents, to make regulations for the safeguarding of all collateral, bonds, Federal reserve notes, money, or property of any kind deposited in the hands of such agents, and said board shall perform the duties, functions, or services specified in this chapter, and make all rules and regulations necessary to enable said board effectively to perform the same.

§248(o) The Board of Governors of the Federal Reserve System shall make and promulgate from time to time regulations governing the transfer of funds and charges therefor among Federal reserve banks and their branches, and may at its discretion exercise the functions of a clearing house for such Federal reserve banks, or may designate a Federal reserve bank to exercise such functions, and may also require each such bank to exercise the functions of a clearing house for its member banks.

§342. *Deposits; exchange and collection; member and nonmember banks; charges.*

Any Federal reserve bank may receive from any of its member banks, and from the United States, deposits of current funds in lawful money, national-bank notes, Federal reserve notes, or checks, and drafts, payable upon presentation, and also, for collection, maturing notes and bills; or, solely for purposes of exchange or of collection, may receive from other Federal reserve banks deposits of current funds in lawful money, national-bank notes, or checks upon other Federal reserve banks, and checks and drafts, payable upon pre-

sentation within its district, and maturing notes and bills payable within its district; or, solely for the purposes of exchange or of collection, may receive from any nonmember bank or trust company deposits of current funds in lawful money, national-bank notes, Federal reserve notes, checks and drafts payable upon presentation, or maturing notes and bills: *Provided,* Such nonmember bank or trust company maintains with the Federal reserve bank of its district a balance sufficient to offset the items in transit held for its account by the Federal reserve bank; *Provided further,* That nothing in this or any other section of this chapter shall be construed as prohibiting a member or nonmember bank from making reasonable charges, to be determined and regulated by the Board of Governors of the Federal Reserve System, but in no case to exceed 10 cents per $100 or fraction thereof, based on the total of checks and drafts presented at any one time, for collection or payment of checks and drafts and remission therefor by exchange or otherwise; but no such charges shall be made against the Federal reserve banks.

§210.3 *General Provisions.*

In order to afford both to the public and to the banks of the country to the contrary a direct, expeditious and economical system for the collection of items and the settlement of balances, each Federal Reserve bank shall receive and handle cash items and noncash items in accordance with the terms and conditions set forth in this part; and the provisions of this part and the operating letters of the Federal Reserve banks shall be binding upon the sender of a cash item or a noncash item and shall be binding upon each collecting bank, paying bank,

and nonbank payor to which the Federal Reserve bank, or any subsequent collecting bank,. presents, sends, or forwards a cash item or a noncash item received by the Federal Reserve bank.[1]

* * *

§210.9 *Remittance and payment.*

(a) (1) *Cash item.* A paying bank becomes accountable for the amount of each cash item received by it from or through a Federal Reserve Bank at the close of the paying bank's banking day on which the cash item was so received[4] if it retains such item after the close of such banking day, unless, prior to such time, it pays or remits for the item as herein provided. Payment or remittance therefor shall be effective on such day of receipt by:

(i) debit to an account on the books of a Federal Reserve Bank; or

(ii) payment in cash; or

(iii) in the discretion of the Federal Reserve Bank, any other form of payment or remittance:

Provided, that the proceeds of any such payment or remittance in any form herein stated shall be available to the Federal Reserve Bank not later than the close

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[1]§210.3 became effective July 26, 1967. At that time, however, the remaining sections of Reg J were substantially the same as the California Commercial Code. (See *Clarke and Squillante,* The Law of Bank Deposits, Collections and Credit Cards (1970), p. 109.)

[4]A cash item received by a paying bank shall be deemed to have been received by the bank on its next banking day if the item is received under one of the following circumstances: (1) on a day other than a banking day for it, or (2) on a banking day for it, but (a) after its regular banking hours, or (b) after a "cut-off hour" established by it in accordance with applicable State law, or (c) during afternoon or evening periods when it is open for limited functions only.

of the banking day for such Federal Reserve Bank on the day on which such item was so received by the paying bank. If the banking day on which an item is received by a paying bank is not a banking day for the Federal Reserve Bank from which the item was received, any payment or remittance made hereunder shall be effected on the banking day of both such Federal Reserve Bank and such paying bank next following the day of receipt of such item.

§210.12 *Return of Cash items.*

(a) A paying bank that receives a cash item from or through a Federal Reserve Bank, otherwise than for immediate payment over the counter, and that pays or remits for such items as provided in §210.9(a) of this Part shall have the right to recover any payment or remittance so made if, before it has finally paid the item, it returns the item before midnight of its banking day next following the banking day of receipt or takes such other action to recover such payment or remittance within such time and by such means as may be provded by applicable State law: *Provided*, that the foregoing provisions shall not extend, nor shall the time herein provided for return be extended by, the time for return of unpaid items fixed by the rules and practices of any clearing house through which the item was presented or fixed by the provisions of any special collection agreement pursuant to which it was presented.

§210.13 *Chargeback of unpaid cash items and noncash items.*

If a Federal Reserve Bank does not receive payment for any cash item in accordance with the provisions of §210.9(a), the amount of such item may be charged back to the sender, regardless of whether or not the

item itself can be returned. If a Federal Reserve Bank does not receive payment in actually and finally collected funds for any cash item or noncash item for which it gave credit subject to payment in actually and finally collected funds, the amount of such item shall be charged back to the sender, regardless of whether or not the item itself can be returned. In the event the amount of the item is charged back, neither the owner or holder of any such item nor the sender shall have the right of recourse upon, interest in, or right of payment from, any reserve balance, clearing account, deposit account, or other funds of the paying bank or of any collecting bank, in the possession of the Federal Reserve Bank. No draft, authorization to charge, or other order, upon any reserve balance, clearing account, deposit account, or other funds in the possession of a Federal Reserve Bank, issued for the purpose of paying or remitting for any cash items or noncash items handled under the terms of this Part, will be paid, acted upon, or honored after receipt by such Federal Reserve Bank of notice of suspension or closing of the bank making the payment or remittance for its own or another's account.

Relevant Sections of Regulation J, Series of 1920 (Superseding Regulation J of 1917).

Check Clearing and Collection

Section 16 of the Federal reserve act authorizes the Federal Reserve Board to require each Federal reserve bank to exercise the function of a clearing house for its member banks, and section 13 of the Federal reserve act, as amended by the act approved June 21, 1917, authorizes each Federal reserve bank to receive from any nonmember bank or trust company, solely for the

purpose of exchange or of collection, deposits of current funds in lawful money, national-bank notes, Federal reserve notes, checks and drafts payable upon presentation, or maturing notes and bills, provided such nonmember bank or trust company maintains with its Federal reserve bank a balance sufficient to offset the items in transit held for its account by the Federal reserve bank.

In pursuance of the authority vested in it under these provisions of law, the Federal Reserve Board, desiring to afford both to the public and to the various banks of the country a direct, expeditious, and economical system of check collection and settlement of balances, has arranged to have each Federal reserve bank exercise the functions of a clearing house for such of its member banks as desire to avail themselves of its privileges, and for such nonmember State banks and trust companies as may maintain with the Federal reserve bank balances sufficient to qualify them under the provisions of section 13 to send items to Federal reserve banks for purposes of exchange or of collection. Such nonmember State banks and trust companies will hereinafter be referred to in this regulation as nonmember clearing banks.

Each Federal reserve bank shall exercise the functions of a clearing house under the following general terms and conditions:

(1) Each Federal reserve bank will receive at par from its member banks and from nonmember clearing

banks in its district, checks[7] drawn on all member and nonmember clearing banks and on all other nonmember banks which agree to remit at par through the Federal reserve bank of their district.

(2) Each Federal reserve bank will receive at par from other Federal reserve banks, and from all member and nonmember clearing banks, regardless of their location, for the credit of their accounts with their respective Federal reserve banks, checks drawn upon all member and nonmember clearing banks of its district and upon all other nonmember banks of its district whose checks are collected at par by the Federal reserve bank.

* * *

(8) In handling items for member and nonmember clearing banks, a Federal reserve bank will act as agent only. The board will require that each member and nonmember clearing bank authorize its Federal reserve bank to send checks for collection to banks on which checks are drawn, and, except for negligence, such Federal reserve bank will assume no liability. Any further requirements that the board may deem necessary will be set forth by the Federal reserve banks in their letters of instruction to their member and nonmember clearing banks. Each Federal reserve bank will also promulgate rules and regulations governing the details of its

[7]A check is generally defined as a draft or order upon a bank or banking house, purporting to be drawn upon a deposit of funds, for the payment at all events of a certain sum of money to a certain person therein named, or to him or his order, or to bearer, and payable instantly on demand.

operations as a clearing house, such rules and regulations to be binding upon all member and nonmember banks which are clearing through the Federal reserve bank.

Relevant Sections of Regulation J, Series of 1924 (Superseding Regulation J of 1920).

Check Clearing and Collection

Section I. Statutory Provisions

Section 16 of the Federal reserve act authorizes the Federal Reserve Board to require each Federal reserve bank to exercise the functions of a clearing house for its member banks, and section 13 of the Federal reserve act, as amended by the act approved June 21, 1917, authorizes each Federal reserve bank to receive from any nonmember bank or trust company, solely for the purposes of exchange or of collection, deposits of current funds in lawful money, national-bank notes, Federal reserve notes, checks and drafts payable upon presentation or maturing notes and bills, provided such nonmember bank or trust company maintains with its Federal reserve bank a balance sufficient to offset the items in transit held for its account by the Federal reserve bank.

Section II. General Requirements

In pursuance of the authority vested in it under these provisions of law, the Federal Reserve Board, desiring to afford both to the public and to the various banks of the country a direct, expeditious, and economical system of check collection and settlement of balances, has arranged to have each Federal reserve bank exercise the functions of a clearing house and collect checks for such of its member banks as desire

to avail themselves of its privileges and for such nonmember State banks and trust companies as may maintain with the Federal reserve bank balances sufficient to qualify them under the provisions of section 13 to send items to Federal reserve banks for purpose of exchange or of collection. Such nonmember State Banks and trust companies will hereinafter be referred to as nonmember clearing banks.

Each Federal reserve bank shall exercise the functions of a clearing house and collect checks under the general terms and conditions hereinafter set forth.

Section III. Checks Received for Collection

(1) Each Federal reserve bank will receive at par from its member banks and from nonmember clearing banks in its district, checks[12] drawn on all member and nonmember clearing banks, and checks drawn on all other nonmember banks which are collectable at par in funds acceptable to the Federal reserve bank of the district in which such nonmember banks are located.

(2) Each Federal reserve bank will receive at par from other Federal reserve banks, and from all member and nonmember clearing banks in other Federal reserve districts which are authorized to route direct for the credit of their respective Federal reserve banks, checks drawn on all member and nonmember clearing banks of its district, and checks drawn on all other nonmember banks of its district which are collectable at par in funds acceptable to the collecting Federal reserve bank.

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[12]A check is generally defined as a draft or order upon a bank or banking house, purporting to be drawn upon a deposit of funds, for the payment at all events of a certain sum of money to the order of a certain person therein named, or to him or his order, or to bearer, and payable on demand.

(3) No Federal reserve bank shall receive on deposit or for collection any check drawn on any nonmember bank which cannot be collected at par in funds acceptable to the Federal reserve bank of the district in which such nonmember bank is located.

* * *

Section VI. Other Rules and Regulations

Each Federal reserve bank shall also promulgate rules and regulations not inconsistent with the terms of the law or of this regulation, governing the details of its check clearing and collection operations. Such rules and regulations shall be set forth by the Federal reserve banks in their letters of instruction to their member and nonmember clearing banks and shall be binding upon any member or nonmember clearing bank which sends any check to such Federal reserve bank for collection or to any other Federal reserve bank for the account of such Federal reserve bank for collection.

Relevant Sections of the California Commercial Code.

§4103. *Variation by Agreement; Measure of Damages; Certain Action Constituting Ordinary Care.* (1) The effect of the provisions of this division may be varied by agreement except that no agreement can disclaim a bank's responsibility for its own lack of good faith or failure to exercise ordinary care or can limit the measure of damages for such lack or failure; but the parties may by agreement determine the standards by which such responsibility is to be measured if such standards are not manifestly unreasonable.

(2) Federal Reserve regulations and operating letters, clearinghouse rules, and the like, have the effect of agreements under subdivision (1), whether or not

specifically assented to by all parties interested in items handled.

* * *

Uniform Commercial Code Comment

* * *

3. * * *

Federal Reserve regulations. Various sections of the Federal Reserve Act (12 U.S.C.A. §221 et seq.) authorize the Board of Governors of the Federal Reserve System to direct the Federal Reserve banks to exercise bank collection functions. For example, Section 16 (12 U.S.C.A. §248(o)) authorizes the Board to require each Federal Reserve bank to exercise the functions of a clearing house for its members and Section 13 (12 U.S.C.A. §342) authorizes each Federal Reserve bank to receive deposits from non-member banks solely for the purposes of exchange or of collection. Under this statutory authorization the Board has issued Regulation J (Check Clearing and Collection), which has been infrequently amended over the many years during which it has been in force. (Regulation G, issued under comparable statutory authority, covers the handling of "non-cash items".) Where regulations issued by the Board in pursuance of its statutory mandate may be said to have some force of law and constitute an effective means of maintaining flexibility, it is appropriate to provide that such regulations may vary this Article even though not specifically assented to by all parties interested in items handled.

* * *

§4301. *Deferred Posting; Recovery of payment by Return of Items; Time of Dishonor.* (1) Where an authorized settlement for a demand item (other than a documentary draft) received by a payor bank other-

wise than for immediate payment over the counter has been made before midnight of the banking day of receipt the payor bank may revoke the settlement and recover any payment if before it has made final payment (subdivision (1) of Section 4213) and before its midnight deadline it

(a) Returns the item; or

(b) Sends written notice of dishonor or nonpayment if the item is held for protest or is otherwise unavailable for return.

(2) If a demand item is received by a payor bank for credit on its books it may return such item or send notice of dishonor and may revoke any credit given or recover the amount thereof withdrawn by its customer, if it acts within the time limit and in the manner specified in the preceding subdivision.

* * *

§4302. *Payor Bank's Responsibility for Late Return of Item.* In the absence of a valid defense such as breach of a presentment warranty (subdivision (1) of Section 4207), settlement effected or the like, if an item is presented on and received by a payor bank the bank is accountable for the amount of

(a) A demand item other than a documentary draft whether properly payable or not if the bank, in any case where it is not also the depositary bank, retains the item beyond midnight of the banking day of receipt without settling for it or, regardless of whether it is also the depositary bank, does not pay or return the item or send notice of dishonor until after its midnight deadline; or

* * *

APPENDIX D.

Opinion of the United States Attorney General, 31 Ops. Atty. Gen. 245 (1918).

FEDERAL RESERVE BANKS—CHARGES FOR THE COLLECTION AND PAYMENT OF CHECKS.

The limitations contained in section 13 of the Federal Reserve Act, as amended, relating to charges for the collection and payment of checks, do not apply to State banks not connected with the Federal reserve system as members or depositors. Checks on banks making such charges cannot, however, be cleared or collected through Federal reserve banks.

Department of Justice,
March 21, 1918.

Sir: You have requested my opinion as to whether the limitations contained in section 13 of the Federal Reserve Act relating to charges for the collection and payment of checks can be held to apply to State banks which are neither members of the Federal reserve system nor depositors in Federal reserve banks.

As originally enacted, the first paragraph of section 13 (38 Stat. 263) read as follows:

"Any Federal reserve bank may receive from any of its member banks, and from the United States, deposits of current funds in lawful money, national-bank notes, Federal reserve notes, or checks and drafts upon solvent member banks, payable upon presentation; or, solely for exchange purposes, may receive from other Federal reserve banks deposits of current funds in lawful money, national-bank notes, or checks and drafts upon

solvent member or other Federal reserve banks, payable upon presentation."

In section 16, apparently as the basis of a system of check clearing or collection, it is provided that Federal reserve banks *shall receive on deposit at par* checks and drafts on member and other Federal reserve banks; and the Federal Reserve Board is authorized to fix by rule the *charges to be collected by member banks from patrons whose checks are cleared through the Federal reserve bank* and any charge for the service of clearing or collection rendered by the Federal reserve bank.

It will be noted that under the first paragraph of section 13 in its original form the only classes of banks which might be depositors in and thus clear through a Federal reserve bank were its member banks and other Federal reserve banks, and the only checks and drafts specified as receivable on deposit were checks and drafts drawn upon member banks or upon other Federal reserve banks.

The acts of September 7, 1916 (39 Stat. 752), and June 21, 1917 (40 Stat. 235), so amended the first paragraph of section 13 as to extend the clearing and collection facilities of the Federal reserve system to include checks and drafts generally, to make these facilities directly available to nonmember banks, and to establish the limitations as to charges referred to in the question submitted. The paragraph as so amended reads as follows:

"Any Federal reserve bank may receive from any of its member banks, and from the United States, deposits of current funds in lawful money, national-bank notes, Federal reserve notes, or checks, and drafts, payable upon presentation, and also, for collection, matur-

ing notes and bills; or, solely for purposes of exchange or of collection, may receive from other Federal reserve banks deposits of current funds in lawful money, national-bank notes, or checks upon other Federal reserve banks, and checks and drafts, payable upon presentation within its district, and maturing notes and bills payable within its district; or, solely for the purposes of exchange or of collection, may receive from any nonmember bank or trust company deposits of current funds in lawful money, national-bank notes, Federal reserve notes, checks and drafts payable upon presentation, or maturing notes and bills: *Provided*, Such nonmember bank or trust company maintains with the Federal reserve bank of its district a balance sufficient to offset the items in transit held for its account by the Federal reserve bank: *Provided further*, That *nothing in this* or any other section of this *Act shall be construed as prohibiting a member or nonmember bank from making reasonable charges, to be determined and regulated by the Federal Reserve Board, but in no case to exceed 10 cents per $100* or fraction thereof, based on the total of checks and drafts presented at any one time, *for collection or payment of checks and drafts and remission therefor* by exchange or otherwise; *but no such charges shall be made against the Federal reserve banks.*" [Italics mine.]

The limitations as to charges referred to in the question submitted are contained in the second proviso quoted above. This proviso, apparently recognizing an existing right of member and nonmember banks to make reasonable charges for the collection or payment of checks and drafts and remission therefor by exchange or otherwise, provides (1) that these charges are "to be determined and regulated by the Federal Reserve

Board, but in no case to exceed 10 cents per $100," but (2) that "no such charges shall be made against the Federal reserve banks."

Clearly these limitations apply to national banks, which are compelled to be member banks, to such State banks as become member banks by voluntarily accepting the terms and provisions of the Federal reserve act, and to such other State banks as do not become member banks but by becoming depositors in Federal reserve banks upon the conditions specified avail themselves directly of the facilities of the Federal reserve clearing system.

The specific question to be determined is whether these limitations apply to nonmember State banks which do not become depositors but checks upon which may pass through Federal reserve banks in process of clearing or collection.

The theory and scheme of the Federal reserve legislation seems inconsistent with the purpose on the part of Congress to subject State banks *against their will* to Federal control or regulation. State banks are not compelled to become members of the Federal reserve system or depositors therein. Those possessing the necessary qualifications are, however, invited to become members. They are not only free to accept or decline, but if they accept remain at liberty to withdraw from the system. (Sec. 9.) By section 13, as amended, State banks not desiring to become members or too small to be eligible for membership are likewise *invited* to share in the clearing and collection facilities of the system by becoming depositors in Federal reserve banks. But they may accept or reject the invitation, and if they become depositors may close their accounts at their pleasure.

It would accordingly seem that the limitations referred to ought not to be regarded as intended to be imposed upon State banks not connected with the Federal reserve system as members or depositors against the will of such banks, unless that intention clearly appears.

The term "nonmember bank," as used in the proviso, may reasonably be construed as referring to a nonmember bank that has become a depositor as authorized in the preceding provisions of the paragraph. If this term is so construed, obviously the provision requiring charges "to be determined and regulated by the Federal Reserve Board, but in no case to exceed 10 cents per $100," will have no application to nonmember State banks which are not depositors in a Federal reserve bank. The broad language of the concluding clause, "no such charges shall be made against the Federal reserve banks," may be construed not as directed against State banks which are not depositors but merely as specifying a condition upon which checks may clear through the Federal reserve banks—in effect a prohibition against the payment of such charges by the Federal reserve banks.

Under this construction, member banks and nonmember banks which are depositors in the Federal reserve banks will be subject to the limitations in the proviso, but nonmember banks which are not depositors will not be subject to the limitations. All, however, will have to adjust their charges among themselves and with their own depositors, the Federal reserve banks being prohibited from paying such charges.

This construction seems to be in harmony with the intention of the framers of the amendment to section 13 embodying the above-mentioned proviso.

The act of June 21, 1917, amending section 13 and other sections of the Federal reserve act, as originally introduced in both the House and Senate, contained no part of the (second) proviso, the section in the proposed amended form ending with the preceding proviso. The Senate, adopting an amendment offered by Senator Hardwick, added the second proviso in the following form:

"*Provided further*, That nothing in this or any other section of this act shall be construed as prohibiting a member or nonmember bank from making reasonable charges, but in no case to exceed 10 cents per $100 or fraction thereof, based on the total of checks and drafts presented at any one time, for collection or payment of checks and drafts and remission therefor by exchange or otherwise." [55 Cong. Rec. 1988.]

It was thought the effect of the Hardwick amendment would be to recognize the right of any bank upon which checks are drawn to make charges against the Federal reserve bank through which such checks might be cleared or collected. The Hardwick amendment was opposed by the Federal Reserve Board, as appears from letters from its governor to Senator Owen and Congressman Glass, chairmen of the respective Committees on Banking and Currency of the Senate and House. (Pp. 1984, 3527.) The President also called attention to the seeming effect of the amendment in a letter to Senator Owen, reading as follows:

"I have been a good deal disturbed to learn of the proposed amendment to the Federal reserve act which

seems to contemplate *charging the Federal reserve banks for payment of checks cleared by them,* or charging the payee of such checks passing through the reserve banks with a commission. I should regard such a provision as most unfortunate and as almost destructive of the function of the Federal reserve banks as a clearing house for member banks, a function which they have performed with so much benefit to the business of the country.

"I hope most sincerely that this matter may be adjusted without interfering with this indispensable clearing function of the banks." [P. 3761.]

In conference, apparently as the result of the letters of the governor of the Federal Reserve Board and the President, the proviso took its present form, two changes being made by the conferees: *First,* the charges which member or nonmember banks may make were made subject "to be determined and regulated by the Federal Reserve Board;" and *second,* the final clause was added, "but no such charges shall be made against the Federal reserve banks."

In presenting the conference report to the Senate, Senator Owen emphasized the importance of not interfering with the clearing functions of the Federal reserve banks, explained that under the proviso as amended — "the banks can charge each other for making these accommodations if they like, and they can adjust that to their own satisfaction with one another, without troubling the reserve banks,"—

and apparently conceded that State banks not connected as members or depositors with the Federal reserve system could not be subjected to Federal legislation. [P. 3761.]

Mr. Glass, in presenting the report to the House, said:

"The Congress has no control whatsoever over nonmember banks. It cannot regulate their charges, and will not regulate them if this Hardwick amendment should prevail. * * * This House has no control over the nonmember bank in this matter. Even the Federal Reserve Board has no control over their operations unless they voluntarily join the voluntary collection system established by the Federal Reserve Board." [P. 3526.]

And further:

"No nonmember bank that does not voluntarily join the collection system established by the Federal Reserve Board will be specifically affected. No law that we pass here can directly affect them. The only way they can be affected is incidental." [P. 3528.]

It thus seems clear that the proviso was understood by Congress as designed to protect the clearing functions of the Federal reserve banks, and not directed at State banks which have no connection as members or depositors with the Federal reserve system, and upon which it was considered the effect of the proviso could be only incidental.

It may be urged, and is probably true, that the proviso will necessarily affect the practice of State banks, though not members or depositors, as to making charges for the payment of checks drawn upon them. With the concentration of reserve balances in Federal

reserve banks as required by the Federal Reserve Act, the Federal reserve clearing system may offer the only adequate and convenient facilities for clearing or collecting checks drawn upon banks at a distance, and depositors may find it inadvisable to maintain accounts with banks upon which checks cannot be cleared or collected by the use of these facilities.

The Federal reserve act, however, does not command or compel these State banks to forego any right they may have under the State laws to make charges in connection with the payment of checks drawn upon them. The act merely offers the clearing and collection facilities of the Federal reserve banks upon specified conditions. If the State banks refuse to comply with the conditions by insisting upon making charges against the Federal reserve banks, the result will simply be, so far as the Federal Reserve Act is concerned, that since the Federal reserve banks cannot pay these charges they cannot clear or collect checks on banks demanding such payment from them.

From what has been said it follows that, in my opinion, the limitations contained in section 13, relating to charges for the collection and payment of checks, do not apply to State banks not connected with the Federal reserve system as members or depositors. Checks on banks making such charges cannot, however, be cleared or collected through Federal reserve banks.

Respectfully,

T. W. GREGORY.

To The President.

EXHIBIT E.

Portions of Record, pp. 414-416.

(a) In the Board's press release of March 27, 1972, it is stated:

> "Congress has charged the Federal Reserve System with the responsibility for providing a nationwide mechanism for the transfer of funds and collection of checks."

(b) In announcing the Regulation J Amendments the Board's press release of June 22, 1972, states that the amendments will:

> "Require all banks, also regardless of location, served by the Federal Reserve check collection system (virtually all of the nation's banks) to pay—in immediately collectible funds—for checks drawn on them, the same day the Federal Reserve presents the checks for payment."

(c) In the Federal Reserve Bulletin for July, 1972, at page 626, it is stated:

> "The change in Regulation J requires all banks to whom the Federal Reserve presents checks for payment, both member and nonmember and regardless of location, to remit in immediately available funds on the same day the checks are presented."

(d) When the Washington, D.C. District Court issued a temporary restraining order preventing the imposition of the Regulation J Amendments the Board announced it was not "feasible to fragment implementation of the amendments to Regulation J" and accord-

ingly the Board "acted to postpone as to all banks implementation of the amendments to Regulations D and J." (Affidavit of David C. Melnicoff [Deputy Executive Director of the Board of Governors of the Federal Reserve System] filed herein in Opposition to Plaintiffs' Motion for a Preliminary Injunction) [R. 212] Although the Board has never explained why it was impossible to "fragment" the implementation of the Regulation J Amendments, it can be for no other reason than that the concept of a "universal check collection system" requires that banks be bound by Regulation J.[5]

(e) In discussing regional check processing centers (RCPCs) Mr. Melnicoff, at page 10, line 1 of the Affidavit above cited, [R. 208] states:

> "However, it was apparent that payment of checks in immediately available funds would have to be made universal if remittance and interbank float were to be reduced on a national scale and the RCPC's were to be part of a truly national network."

and again on page 10, line 29: [R. 208]

> "The need to strengthen and extend RCPC and make immediate payment universal coincided with the timing of reserve structure reform."

(f) In discussing a transitional period in which there would be both checks and electronic transfers, Defend-

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[5]The inconsistency of the Board's position was not overlooked by commentators. See *Pratt's Letter* of October 6, 1972, attached hereto as Exhibit "C". [not attached in this Appendix]

ants assert such a dual system would not be compatible with deferred check payment.[6] It follows from this statement that Defendants are trying to force all banks into the mold of same-day payment by insisting the Regulation J Amendments apply to *all* banks.

(g) Despite the fact that by Defendants' own count there are less than 200 "non-par" banks, the Board is not content to allow even these few banks to remain outside of the Federal Reserve check collection system. The Board's Annual Report for 1969, page 300, and the Board's Annual Report for 1970, page 188, each assert the need for congressional legislation to force the non-par banks into the check collection system.

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[6]Defendants' Memorandum in Opposition to Plaintiffs' Motion for Preliminary Injunction, pp. 7-8. [R. 95-96]

In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-432

COMMUNITY BANK, ET AL., PETITIONERS

v.

FEDERAL RESERVE BANK OF SAN FRANCISCO, AND BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENTS IN OPPOSITION

Petitioners contend that Regulation J of the Federal Reserve System, as applied to nonmember, nondepositor banks, is inconsistent with the Uniform Commercial Code and unauthorized by federal statute.

On June 21, 1972, the Board of Governors of the Federal Reserve System approved changes in Regulation J, 12 C.F.R. 210 (Pet. App. C, pp. C-2 to C-5), which governs the collection of checks and other items by Federal Reserve Banks. Petitioners are state-chartered banks that are neither members of nor affiliated with the Federal Reserve System.

Briefly stated, the changes in Regulation J affect both the time and manner in which payor banks must settle for demand items presented for collection by Reserve Banks. Prior to the amendments banks were permitted to pay demand items, presented by Reserve Banks for payment, by remitting a draft on another bank by midnight of the banking day of receipt of the item. By the time the draft could in turn be collected by the Federal Reserve Bank, approximately two days had passed since presentation. This delay, or "float," represented a loss in liquidity to the Federal Reserve Bank, and a corresponding gain to banks such as petitioners.

The amendments to Regulation J advance the payment time to the close of business on the day of receipt, and settlement for an item may be revoked only if payment is made prior to this time. The amendments also require payment in immediately available funds, thus eliminating drafts drawn on other banks as permissible forms of payment.[1]

The purpose of the amendments is to increase the speed of the Federal Reserve's check collection services, and to reduce the "float", which in the past has approximated $2 billion each day.

Petitioners challenge the amendments to Regulation J on two broad grounds. First, they urge that the changes are inconsistent with the time and manner of settlement provisions contained in California's enactment of the Uniform Commercial Code, which they contend should govern the operations of nonmember banks chartered under the laws of the State of California. Second, they argue that, to the extent that the amendments attempt to bind payor banks that are not members of the Federal Reserve System, the amendments to Regulation J exceed the power conferred on the Board under the Federal Reserve Act.

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[1]Prior to the amendments the time and manner of settlement provisions of Regulation J and the Uniform Commercial Code (as adopted in the California Commercial Code) were virtually identical.

Under the amendments the collecting Federal Reserve Bank is required to charge back to the sender the amount of any check for which payment is not made by the close of business on the banking day of receipt (Pet. App. C, pp. C-4 to C-5).

The district court rejected each of these contentions, and upheld the Board's amendments to Regulation J (Pet. App. A, pp. A-1 to A-19). The court of appeals affirmed (Pet. App. B; 500 F.2d 282). Accord, *Independent Bankers Association* v. *Board of Governors of the Federal Reserve System*, 500 F.2d 812 (C.A.D.C.).[2] There is no conflict among the circuits or with any decision of this Court, and accordingly there is no occasion for plenary review.

1. The court of appeals correctly decided that the revisions of Regulation J were not inconsistent with California law (Pet. App. B, pp. B-5 to B-12). Section 4103(2) of the California Commercial Code provides that "Federal Reserve regulations and operating letters, clearing-house rules, and the like, have the effect of agreements * * * whether or not specifically assented to by all parties interested in items handled." The Code also provides (Section 4103(1)) that other provisions relating to bank collections may be varied "by agreement." The effect of these two interlocking provisions is to provide that provisions of the Code otherwise applicable to bank collections may be varied by regulations of the Federal Reserve System; in effect, the federal regulations are incorporated by the Code into state law. See Uniform Commercial Code (1958 Supp. to 1957 Official Text), Section 4-103, official Comment 3: "Consequently, such official or quasi-official rules may, standing by themselves * * * vary the effect of the provisions of Article 4 [of the Code]."

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[2]The District of Columbia Circuit also there held that the Federal Reserve Board had sufficiently taken into account the interests of nonmember banks in its amendments to Regulation J.

In any event, petitioners' claim (Pet. 17-21) that the court of appeals has misconstrued California state law presents no issue warranting review by this Court.

2. Petitioners' argument that Regulation J exceeds the power of the Federal Reserve System, as construed in *Farmers and Merchants Bank of Monroe* v. *Federal Reserve Bank of Richmond*, 262 U.S. 649, is inaccurate. The court of appeals fully answered this contention in its opinion, on which we rely (Pet. App. B, pp. B-13 to B-16):

> The authority of Reserve Banks * * * includes the power to collect checks drawn on nonmember banks. *See American Bank and Trust Co.* v. *Federal Reserve Bank of Atlanta*, 262 U.S. 643 (1923). The Board is also authorized to promulgate rules and regulations necessary to the performance of its functions. 12 U.S.C. §248(i). *See also* 12 U.S.C. §248(o).
>
> * * * * *
>
> There is nothing in [*Farmers and Merchants Bank*] that supports the appellants. The Court only recognized the right of a state to alter the common law rules relating to bank collections. Here we only recognize the right of the Federal Reserve to promulgate rules with respect to check collections in a manner countenanced by applicable state law. Neither the Federal Reserve here nor North Carolina in *Farmers and Merchants Bank* has acted beyond its power.
>
> * * * * *

> Since the amendments to Regulation J do not, in our view, represent an attempt to establish a universal system of check clearance, appellants' reliance on *Farmers and Merchants Bank* is misplaced. Because the State Banks are not required to use Federal Reserve routing numbers on their checks, and because alternatives exist to the use of such numbers, the system must be characterized as essentially voluntary. Under such circumstances, the amendments to Regulation J cannot be viewed as an attempt by the Board to establish a universal system of check collection. If the amended Regulation J proves too onerous to the State Banks, they are free to remove themselves from the system. [Footnote omitted.]

If they wish, petitioners may avoid the effect of Regulation J by declining to have their checks processed through the Federal Reserve's check collection system. Such removal is feasible; more than 200 banks that do not accede to the Federal Reserve System's desire to clear all checks at par have established alternate methods of check payment. See Pet. App. A, p. A-15. Although petitioners assert that this method would be inconvenient because it would require that "each and every one of Petitioners' depositors have new checks printed and encoded with a new number" (Pet. 19), petitioners are not entitled to use this allegation of inconvenience to compel the Federal Reserve System permanently to provide them with the substantial unearned benefits that now accrue to them because of the "float."

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

DECEMBER 1974.